APPENDIX

In the Supreme Court of the United States

OCTOBER TERM, 1968

No. [redacted] 17

UNITED STATES OF AMERICA, PETITIONER

v.

THE DONRUSS COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR CERTIORARI FILED DECEMBER 26, 1967
CERTIORARI GRANTED APRIL 22, 1968

In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 963

UNITED STATES OF AMERICA, PETITIONER

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THE DONRUSS COMPANY

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DOCKET ENTRIES IN THE DISTRICT COURT

April 7, 1964	Filed Complaint
June 8, 1964	Filed Answer
February 4, 1965	Filed Notice to Take Oral Deposition of John H. Daly, Treasurer of Philadelphia Chewing Gum Corp.
February 5, 1965	Filed Answers to Interrogatories and Cross-Interrogatories Propounded on Plaintiff's Behalf to J. W. Feighner
February 19, 1965	Filed Jury Verdict—Interrogatory No. 1 answered "Yes" and Interrogatory No. 2 answered "No"
March 3, 1965	Filed Judgment in favor of Donruss Co. —Plaintiff to recover $35,152.91 plus interest paid by plf. April 30, 1962—copy handed U. S. Attorney
March 11, 1965	Filed Amendment to Judgment—Plf. to recover $38,770.19 plus interest on said amount from 4/30/62 at 6%—copy mailed Tom Mitchell, Jr. and U. S. Atty.
March 11, 1965	Filed Motion for Judgment Notwithstanding the Verdict and in the Alternative for a Partial New Trial
April 2, 1965	Filed Order Overruling Defendant's Motion for Judgment NOV and for Partial New Trial
May 28, 1965	Filed Notice of Appeal by defendant
July 1, 1965	Filed Order Extending Time to Docket Appeal—copies mailed attorneys
August 4, 1965	Filed Motion for Order Directing the United States Clerk for the Western District of Tennessee to Include Certain Documents in and as Part of the Record of this Case

DOCKET ENTRIES IN THE DISTRICT COURT

August 23, 1965	Filed Order Sustaining Defendant's Motion for Order Directing the United States District Court Clerk to Include Certain Documents in the Record on Appeal
August 23, 1965	Filed copy of Order entered Dec. 16, 1964, by U. S. District Judge Allan K. Grim of the U. S. District Court for the Eastern District of Pennsylvania in matter No. "M2848"
August 23, 1965	Filed copy of Notice of Appeal to U. S. Court of Appeals for the Third Circuit from Order entered Dec. 16, 1964
August 23, 1965	Filed copy of Order entered February 9, 1965, by U. S. Court of Appeals for Third Circuit staying Order of U. S. District Court of Dec. 16, 1964, etc. Consent

DOCKET ENTRIES IN THE COURT OF APPEALS

August 26, 1965	Certified record (5 vol. pleadings and 5 vol. testimony), filed; and cause docketed.
September 2, 1965	Appearance of counsel for Appellee.
September 3, 1965	Appearance of counsel for Appellant.
September 3, 1965	Statement of Appellant as to contents of appendix
September, 17, 1965	Stipulation: Appellant's brief to 10/25/65 (Approved).
October 12, 1965	Twenty copies of Appendix to Brief for Appellant
October 25, 1965	Twenty copies of Brief for Appellant

DOCKET ENTRIES IN THE COURT OF APPEALS

October 25, 1965	Appearance of counsel for Appellant
October 25, 1965	Proof of service of brief for Appellant
November 20, 1965	Twenty copies of Brief for Appellee
November 20, 1965	Proof of service of brief for Appellee
November 29, 1965	Twenty copies of Supplement to Reply Brief for Appellee, with proof of service
December 14, 1966	Cause argued and submitted (Before: O'Sullivan, Celebrezze and Battisti, JJ.)
September 27, 1967	Judgment of the District Court reversed and cause remanded for a new trial P-180
September 27, 1967	Opinion by Battisti, D.J. 10pp
October 18, 1967	Mandate issued (No costs taxed) Opinion with mandate

COMPLAINT

[Caption omitted]

I

This is an action to recover Federal Income Tax paid by plaintiff, which action arises under and is controlled by the Internal Revenue Code of 1954 as amended, this Court has jurisdiction by virtue of Title 28 U.S. Code § 1346(a)(1).

II

Plaintiff is a corporation with its principal place of business in Memphis, Shelby County, Tennessee.

III

Plaintiff duly and regularly filed its income tax returns covering its fiscal years ended January 31, 1960 and January 31, 1961 with the District Director of Internal Revenue for the District of Tennessee and paid to said District Director the amount of income tax shown thereon to be due, within the time prescribed by law.

IV

Thereafter, the Internal Revenue Service assessed additional income tax for the fiscal year ended January 31, 1960 against plaintiff under § 531 of the Internal Revenue Code of 1954, known as the "Accumulated Earnings Tax" in the amount of $24,653.52 and also assessed interest theron [in the amount of, $3,643.36.] Thereafter, the Internal Revenue Service also assessed additional income tax for the fiscal year ended January 31, 1961 against plaintiff under § 531 of the Internal Revenue Code of 1954, known as the "Accumulated Earnings Tax" in the amount of $10,499.39 and also assessed interest thereon [in the amount of $1,085.75.] The said alleged deficiency in tax for the respective years under Section 531, together with the said interest thereon, were paid by plaintiff to the District Director of Internal Revenue at Nashville, Tennessee on or about April 30, 1962.

V

Plaintiff would show and alleges that the said deficiencies alleged by the Internal Revenue Service under § 531, et seq., of the Internal Revenue Code of 1954 were erroneously applied and that these additions to tax for each said year were illegally collected from plaintiff. The accumulated earnings as to which these additions to tax for the said years were assessed had been accumulated for the reasonable and the reasonably anticipated business needs of plaintiff. The said accumulated earnings had not been accumulated during either of the said years for the purpose of reducing, minimizing or avoiding taxation of any officer, stockholder or any other person in interest with plaintiff. Plaintiff has not been allowed the accumulated earnings credit for either of said fiscal years to which plaintiff is entitled under the Internal Revenue Code of 1954.

VI

On or about July 10, 1963, plaintiff filed with the District Director of Internal Revenue at Nashville, Tennessee a Claim for Refund covering its said fiscal year ended January 31, 1960, which claim was for the sum of $24,653.52 as accumulated earnings tax, or such larger amount legally refundable, together with legal interest. On or about July 10, 1963 plaintiff executed and filed with the District Director of Internal Revenue at Nashville, Tennessee a Claim for Refund covering its said fiscal year ended January 31, 1961, which claim was for the sum of $10,499.39 as accumulated earnings tax, or such larger amount legally refundable, together with legal interest. Both said Claims for Refund were made on Form 843, for such purposes provided by the Treasury Department and were presented and delivered to said District Director on or before July 10, 1963. On information and belief, plaintiff alleges that both said claims were processed and considered by appropriate Internal Revenue Service personnel in accordance with the Internal Revenue Code and Regulations thereunder issued by the Secretary of the Treasury.

VII

More than six months have expired since the receipt by said District Director of this plaintiff's said Claims for Refund with respect to additional tax and interest paid by it for its fiscal years ended January 31, 1960 and January 31, 1961. On or about April 3, 1964, plaintiff received by certified mail from the District Director of Internal Revenue Service at Nashville, Tennessee Form L-60 formally disallowing plaintiff's above-described Claim for Refund covering its fiscal year ended January 31, 1960 and a similar form by said District Director disallowing its above-described Claim for Refund with respect to its fiscal year ended January 31, 1961. The said Form L-60 with respect to the period ended January 31, 1960 and with respect to the period ended January 31, 1961 were both dated April 1, 1964; plaintiff's claims with respect to each of the two said years was disallowed in full by the said District Director. Plaintiff is entitled to bring this suit for refund under the provisions of Section 6532(a)(1) of the Internal Revenue Code of 1954.

VIII

The assessment of the additional tax for plaintiff's fiscal year ended January 31, 1960 and the assessment of the additional tax for plaintiff's fiscal year ended January 31, 1961 were erroneously made, said amounts of such taxes and the interest thereon were illegally collected and exacted from the plaintiff by the said District Director under color of the Internal Revenue laws.

IX

Defendant therefore owes plaintiff the aforesaid additional income tax and interest resulting from the illegal and erroneous application of the accumulated earnings tax to plaintiff's fiscal year ended January 31, 1960 and to plaintiff's fiscal year ended January 31, 1961, together with the legal interest on said amount.

WHEREFORE, plaintiff demands judgment against the defendant for the amounts set out in this complaint as owing by defendant to plaintiff and, pursuant to Title 28, U.S. Code § 2402, plaintiff demands a jury to try the issues in this action.

LUCIUS E. BURCH, JR.,
TOM MITCHELL
Attorneys for Plaintiff
128 North Court Avenue
Memphis, Tennessee

ANSWER

Defendant, The United States of America, by and through its attorney, Thomas L. Robinson, United States Attorney for the Western District of Tennessee, for answer to the complaint herein, admits, denies, and alleges as follows:

I, II, III

Admits the allegations of paragraphs I, II and III.

IV

Admits the allegations of paragraph IV, except denies that the interest attributable to the accumulated earnings tax issue for the taxable years ending January 31, 1960 and January 31, 1961 is respectively $3,643.36 and $1,085.75.

V

Denies the allegations of paragraph V.

VI, VII

Admits the allegations of paragraphs VI and VII.

VIII, IX

Denies the allegations of paragraphs VIII and IX.

WHEREFORE, defendant prays for judgment in its favor, for dismissal of the complaint, for costs, and for such other and further relief as the Court may deem just and proper.

United States Attorney

(Tr. 422) LLOYD N. BROWN, JR.

The said witness, having been first duly sworn, testified as follows:

DIRECT EXAMINATION BY MR. WHITE:

Q. State your name please, sir?
A. Lloyd N. Brown, Jr.
Q. Where do you live, Mr. Brown?
A. Washington, Arlington, Virginia.
Q. You work in Washington, D. C.?
A. Yes.
Q. Where are you from; where is your home town?
A. Manhattan, Kansas.
Q. Did you go to school in Kansas?
A. Yes.
Q. What school?
A. Graduated from high school in Manhattan and went to the Kansas State University, which is also in Manhattan.
Q. What did you do at Kansas State University? Did you have any particular area of specialty?
A. I received a Bachelor of Science Degree in Business Administration.
Q. When was that, sir?
A. In 1946.
(Tr. 423) Q. In Business Administration what was your specialty?

A. I took all the courses that they offered in accounting and I also majored in Economics.

Q. What did you do during the period of 1942 to 1945? Were you at college or in the service?

A. I was in the army.

Q. You came back after you finished the Army and went back to college?

A. Yes.

Q. Your college was split between pre-war and post-war? Is that a correct statement?

A. Yes.

Q. Now, what do you do in Washington?

A. My job currently is to receive reports of examinations and make an analysis, and list the reports to determine whether the government is correct or whether the taxpayers are correct in this.

Q. You say you get some examinations from whom? What branch of the government are you talking about?

A. Internal Revenue agents in the field.

Q. How long have you been working for the Internal Revenue?

A. Since June, 1955.

(Tr. 424) Q. Tell us what you have done since 1955 in the Revenue Service?

A. Well, for the most of this period I was an Internal Revenue agent examining returns in the field, corporate, individual returns of all businesses.

Q. When you say "in the field" where do you mean, out in Kansas?

A. In Kansas, yes, sir.

Q. Describe the job of a Revenue Agent a little bit more if you will, please, sir.

A. A Revenue Agent's job is difficult to describe and to do. You have to go out, he must examine the books and accounts of a great variety of businesses and from his knowledge of accounting and economics and business conditions he must make determinations as to the accuracy of those returns.

* * * *

(Tr. 429) A. The other column is the current ratio of current assets to current liabilities as shown on the balance sheet of the company.

In 1950 I did not compute it because there were current assets of some working capital of some Eight Hundred Fifty Thousand Dollars and only about Five or Six Dollars worth of current liabilities. I did not even compute that.

Q. I see. When you say, looking down through 1960, 8/30 to 1, what does that mean, trying to convert that into the language of the layman?

A. That means for every thousand dollars of liability there was Eight Thousand Three Hundred Dollars worth of assets.

Q. Bring it down to one dollar and I think it would be easier for me. $8.30 to every $1.00. You say of current assets?

* * * *

(Tr. 432) Q. As shown in Column 11 would you explain how that relates to the figures in Column 5?

A. Well, as you see, opposite 1954 this Column shows One Million Six Hunderd Twenty-one Thousand Dollars in retained earnings; opposite of 1955 it shows One Thousand Twenty-one Dollars. The difference is somewhat in excess of Eight Hundred Two Thousand Dollars but there was considerable profit made during the year.

Q. It looks like to me it was right at Six Hundred Thousand Dollars difference.

A. Apparently there was about Two Million Dollars profit after taxes.

Q. How many millions?

A. Two Hundred, Two Thousand.

Q. In other words from One Million Six Hundred Twenty-one Thousand Dollars you subtract Eight Hundred Two Thousand Dollars that brings you Eight Hundred Thousand Dollars then; the profits were accumulated?

(Tr. 433) A. That is correct.

Q. Now, what happened in the working capital as of the first of February, 1955; it is down very low to One Hundred Eighty-four Thousand Dollars?

A. That is correct.

Q. Why has that one dropped way down like that if you know?

A. Well, from an examination of the return and my accounting knowledge it is very easy to see when you take Eight Hundred Thirty Thousand Dollars out of a business the working capital is bound to go down because you are either taking that much cash out or you are going to have to borrow that much, both of which reduced the working capital of a business.

Q. You say borrowing is going to reduce the working capital, why is that?

A. It is a liability and the definition of working capital is the total capital less the liability and as I said from the returns it appeared that all the borrowings were of a temporary nature.

* * * *

(Tr. 441) Q. Mr. Brown, would you refer to the exhibits and advise where, if anywhere, it states the amount of the accumulated earnings of The Donruss Company as of the end of January, 1949?

A. I believe I mentioned that that was the first amount shown in Column 5.

Q. That is that One Thousand Three Hundred Ninety-six Dollar figure?

A. That is right.

Q. Now, can you state how long a period that it took for that amount to be accumulated?

A. From the information that I have, the corporation was started in 1946, I believe.

Q. So, that would be between 1946 and this date of January, 1949?

A. That is correct.

Q. Now in Column number 2, I beg your pardon, column 3, 1964, there is a figure of Three Hundred Ninety-three Thousand Dollars. Does that include Three Hundred Seventy-eight Thousand Dollars of stock in the Tom Huston Peanut Company?

A. It does.

Q. In other words that transaction is reflected in this schedule that you have?

A. Yes.

(Tr. 442) Q. And I notice that this Column 10 you have "dividends paid" with the word "none". Would you state what significance that was all the way through?

A. I was unable to determine from the return that any dividend had been paid. It would have shown up on the return if there had been.

* * * *

(Tr. 455)

CROSS EXAMINATION BY MR. BURCH:

Q. Mr. Brown, do you know anything about the bubble gum business?

A. Only what I have studied about it in the last four or five months.

Q. You never were entangled in it before, were you?

A. No, sir.

Q. You never audited the books of a bubble gum Company?

A. No, sir.

Q. You never gave any financial advice as to bubble gum expansion or maintaining its place in industry?

A. No, sir.

Q. You stated you were on, as I understood, a position of review in Washington in which you review reports (Tr. 456) and examinations?

A. That is right.

Q. Did you review the report of the agent that made the examination of the Donruss Company?

A. I did.

Q. When did you review it?

A. I believe it was started in October of 1964, September or October.

Q. You did not review it then until after the assessment had been made, after the tax had been paid and after the suit for refund had been commenced, did you?

A. That is correct.

Q. So, your own connection with The Donruss Company is to get out the file and reports, to get ready to help the government in this lawsuit, is that the facts?

A. That is the usual purpose of soliciting so-called expert testimony.

Q. I take it that your answer to my question is yes?

A. Yes.

* * * *

DEFENDANT'S EXHIBIT No. 48

THE DONRUSS COMPANY

Fiscal Year Ended January 31	1. Current Assets	2. Current Liabilities	3. Net Working Capital	4. Dollars of Current Assets to $1 of Current Liabilities
1949	$ 885,936.63	$ 83,340.90	$802,595.72	$ 10.6 to $1
1950	872,173.32	13.53	872,159.79	
1951	1,086,770.42	95,188.47	991,581.95	11.4 to 1
1952	892,037.55	8,221.75	883,815.80	108.5 to 1
1953	657,522.60	81,734.42	575,788.18	8.0 to 1
1954	870,974.79	91,513.41	779,461.38	9.5 to 1
1955	640,156.35	455,619.90	184,536.45	1.4 to 1
1956	791,611.69	334,363.44	457,248.25	2.4 to 1
1957	815,086.51	201,152.84	613,933.67	4.1 to 1
1958	850,909.32	79,256.83	771,652.49	10.7 to 1
1959	917,418.52	148,770.18	768,648.34	6.2 to 1
1960	965,310.59	116,615.05	848,695.54	8.3 to 1
1961	993,355.72	66,743.48	926,612.24	14.9 to 1
1962	1,007,023.41	36,122.44	970,900.97	27.9 to 1
1963	1,149,409.47	156,128.68	993,280.79	7.4 to 1
1964	1,014,266.33	212,027.12	802,239.21	4.8 to 1

DEFENDANT'S EXHIBIT No. 49

THE DONRUSS COMPANY

	1	2	3	4	5	6	7	8	9	10	11
							Net Profits or (Loss)				
Fiscal Year Ended January 31	Working Capital	Net Fixed Assets	Other Assets	Capital Stock	Accumulated Earnings and Profits	Gross Sales Gum and Candy Business	Farm	Gum and Candy	Total	Dividend Paid	Increase (Decrease) In Accumulated Earnings & Profits
1949	$802,595.72	$653,255.36	$ 590.00	$ 60,000.00	$1,396,441.08	—	—	—	—	—	—
1950	872,159.79	567,348.97		60,000.00	1,379,508.76	$1,139,368.89	$(117,120.88)	$100,188.56	$(16,932.32)	None	$(16,932.32)
1951	991,581.95	589,071.33		60,000.00	1,520,653.28	1,115,688.59	78,842.53	159,106.20	237,948.73	None	141,144.52
1952	883,815.80	575,287.54		60,000.00	1,399,103.34	1,725,121.98	(116,816.87)	143,621.46	26,804.59	None	(121,549.94)
1953	575,788.18	981,815.91	29,167.78	60,000.00	1,526,771.87	1,754,347.23	29,211.97	175,284.78	204,496.75	None	127,668.53
1954	779,461.38	881,119.14	21,129.45	60,000.00	1,621,709.97	1,901,854.01	(76,038.06)	262,089.57	186,051.51	None	94,938.10
	Stock Redemptions		—	(30,000.00)	—	—	—	—	—	—	(802,400.00)
1955	184,536.45	834,690.86	32,061.27	30,000.00	1,021,288.58	2,342,432.74	15,909.20	390,834.77	406,743.97	None	201,978.61
1956	457,248.25	808,745.84	6,022.74	30,000.00	1,242,016.83	2,779,061.38	(2,470.68)	451,072.07	448,601.39	None	220,728.25
1957	613,933.67	806,551.50	6,242.38	30,000.00	1,396,727.55	3,209,355.71	(63,133.33)	393,774.35	330,641.02	None	154,710.72
1958	771,652.49	720,628.58		30,000.00	1,462,281.07	2,521,384.93	(68,607.04)	202,093.90	133,486.86	None	65,553.52
1959	768,648.34	807,161.65	9,000.00	30,000.00	1,554,809.99	2,828,776.65	(66,100.15)	259,369.99	193,269.84	None	92,528.92
1960	848,695.54	798,275.90	21,736.90	30,000.00	1,638,708.34	2,577,624.79	(40,396.48)	206,411.09	166,014.61	None	83,898.35
1961	926,612.24	779,516.23	3,186.90	30,000.00	1,679,315.37	2,609,976.19	603.40	59,550.91	60,154.31	None	40,607.03
1962	970,900.97	739,356.32	3,186.90	30,000.00	1,683,444.19	2,639,848.89	(146,000.55)	122,320.38	(23,680.17)	None	4,128.82
1963	993,280.79	774,127.99	3,186.90	30,000.00	1,740,595.68	2,851,009.66	17,325.67	225,082.74	242,408.41	None	57,151.49
1964	802,239.21	841,089.31	393,186.90	30,000.00	2,006,515.42	3,338,624.65	168,914.77	329,105.23	498,020.00	None	265,919.74

CHARGE OF THE DISTRICT COURT

(Tr. 504) THE COURT: Ladies and Gentlemen of the Jury, this, as you understand, is the lawsuit against the United States of America under Federal Taxing Statutes wherein the plaintiff, The Donruss Corporation, seeks to recover a refund of Federal Income Taxes, with interest, in the total of sum of $39,882.02; That is, the total sum of $39,882.02 for the fiscal year 1960, with proper interest as of April the 30th, 1962, I believe is the date, and $10,499.39 with interest as of April the 30th, 1962 for the fiscal year 1961.

The plaintiff, The Donruss Company, here contends that the earnings of which the within accumulated earnings tax with respect to the fiscal years ending January 31st, 1960 and January 31st, 1961 was assessed, were accumulated for the sole purpose of meeting its reasonable current needs or reasonably anticipated business needs for the two years in question, and, therefore, under the Taxing Statutes herein, is entitled to a refund of the full amounts for each year here in controversy with interest paid to the Government.

For answer to the complaint filed herein, the defendant, The United States of America, denies the corporate earn- (Tr. 505) ings for the two years in question were accumulated for the reasonable current business needs or the reasonably anticipated business needs of the plaintiff corporation. The defendant specifically contends that the earnings in question were not so accumulated but were accumulated with the intent and for the purpose of reducing or minimizing income taxes for its sole stockholder, Don B. Wiener, and that the taxpayer corporation herein is not, under the Statutes, entitled to the refund it seeks in these proceedings.

With respect to the law, it is the duty of the Court to advise you, Members of the Jury, what the governing law is and it is your duty and yours alone to determine the true facts of the case. After you determine what the true facts are, you apply those facts to the law as given you in these instructions by the Court in making up your verdict or verdicts.

It is proper for the Court in the outset, for your better understanding, to give you briefly something of the background of this lawsuit. When The Donruss Company herein paid corporate income taxes for the fiscal years 1960 and 1961 it retained certain monies as earned sur-
(Tr. 506) plus or profits for those years instead of paying it to its sole stockholder as a dividend. Thereafter, the Commissioner of Internal Revenue, upon examination of the corporation's tax returns, assessed against the corporation a total surtax of $39,882.02 on its accumulated earned surplus for the fiscal years 1960 and 1961 here in question, contending that this surplus was accumulated beyond the reasonable current business needs or the anticipated reasonable business needs of the corporation for the two separate years involved. The plaintiff corporation paid the surtax under protest and now seeks in this proceeding, as I say, to recover of the Government for the separate years herein a refund of such payment with interest.

Accumulation of earnings by corporations, you understand, is a major avenue of individual income tax avoidance. Individual proprietorships and partnerships are subject to the full impact of progressive income tax returns, whether or not the earnings are retained in the business. Earnings retained by corporations are not affected by graduated income tax returns until these earnings are distributed to the corporation's stock shareholders and only when these earnings are distributed. Congress imposed an additional tax on corporation earnings which have been accumulated in order to avoid dis-
(Tr. 507) tribution of such earnings in the form of dividends, and thus to avoid personal income tax of a shareholder recipient. Sections 531 and 532(a) of the Internal Revenue Code of 1954 impose an additional tax upon a corporation which permits its earnings and profits to accumulate instead of being divided or distributed, thus avoiding the income tax upon its shareholders. Section 533 provides that where the earnings and the profits of the corporation accumulate beyond the reasonable needs of the business, it is determinative of the purpose to avoid income tax with respect to its shareholders.

Now, here are the Federal Statutes involved. It may be helpful to read them to you at this time. They are as follows:

"Section 531:

"In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income of every corporation described in Section 532, an accumulated earnings tax equal to the sum of twenty-seven and one-half (Tr. 508) percent of the accumulated taxable income not in excess of $100,000 plus thirty-eight and one-half percent of the accumulated taxable income in excess of $100,000."

"Section 532(a):

"The accumulated earnings tax imposed by Section 531 shall apply to every corporation, other than those described in Subsection (b), formed or veiled of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided and distributed."

"Section 533, Subsection (a):

"For purposes of Section 532, the fact that the earnings as a profit of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the (Tr. 509) evidence shall prove to the contrary."

Ladies and Gentlemen of the Jury, having learned what the issues are and what the applicable Statutes provide with respect to this lawsuit, you will next be concerned with the question of where the law places the burden of proof in a case of this kind.

It is the law, and the Court so instructs you, that an assessment of taxes by the Commissioner of Internal Revenue has the support of a presumption of correctness,

and the taxpayer has the burden of proving to the contrary. Therefore, in this case, the burden of proof and the Statute clearly provides is upon the plaintiff, The Donruss Company, to show by a preponderance or greater weight of the evidence that it accumulated the surplus for each of the years here in question, instead of paying them out in dividends, for the reasonable current needs, or the reasonably anticipated needs of the business, for the separate years under consideration, and not for the purpose of reducing or minimizing income taxes of its single stockholder, Mr. Wiener.

The Court instructs you, Members of the Jury, that the preponderance of the evidence in a given case is not alone determined by the number of witnesses testifying (Tr. 510) to a fact, or to a particular state of facts, but, rather, to the weight, credit and value of the aggregate evidence on either side, and of this you jurors must be the exclusive judges.

Now, where the evidence is evenly balanced or in equipoise, as we sometimes say, if you should come to such a point in your deliberations and you are unable to determine in your own minds which way the scales should turn, then the Court instructs you that you must find against that party upon whom the burden of proof has been cast and in accordance with these instructions.

Ladies and Gentlemen of the Jury, as you understand, the important and controlling issue in this lawsuit, where the plaintiff taxpayer seeks to recover a tax refund, is whether the income accumulated by the plaintiff corporation for the separate years herein was for the reasonable current business needs, or reasonably anticipated business needs of the corporation, for the two separate years, as I say, or was held back to avoid taxes on dividends of the company's sole stockholder. Stated another way, it would be for you to determine from the evidence and in accordance with the Court's instructions, whether the (Tr. 511) monies retained by the corporation were for reasonable purposes of the business or whether they were withheld to avoid personal taxes on dividends in the hands of the company's sole stockholder, Mr. Wiener.

You understand, the accumulated earnings tax, as exacted by the Government, is under a Statute, as the Court has stated, designed to defeat any plans to avoid a shareholder's just taxes. Again, as stated, after payment of regular corporate taxes by corporations, the accumulated earnings tax is an extra tax which is computed on any corporate profits or earnings which have been permitted to accumulate and which should have been distributed as dividends to the corporate stockholders.

If you find any of the earnings and profits of the plaintiff for a given year in question were allowed to accumulate beyond the reasonable needs of the business, for that particular year, this shall be determinative of the purpose to avoid the income tax with respect to its sole shareholder, for that year, unless, of course, as the Court has said, that the taxpayer proves the contrary by a preponderance of the evidence.

There is no fixed formula in Section 531 penalty case (Tr. 512) as this, Ladies and Gentlemen, for determining whether the earnings retained by a corporation are held by it for the purpose of avoiding of taxes of the stockholders or held for the reasonably anticipated needs of the business. Each case must turn upon its own peculiar facts and circumstances. There are, however, certain recognized guides which you may consider as being helpful in arriving at a correct solution of these issues. Among such tests or guides, are the following which you may apply for each of the separate years herein in your consideration of this case:

1. An accumulation of earnings is in excess of the reasonably present or current needs of the reasonably anticipated future needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future purposes or needs of a business.

2. The business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake.

(Tr. 513) 3. In order for a corporation to justify an accumulation of earnings or profits for reasonably anticipated needs, there must be an indication that the needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such earnings need only to be used within a reasonable time after accumulation, depending upon all the facts and circumstances relating to the future needs of the corporation. Care must be given to correctly apportion the weight of the evidence where the plans for future needs of the business are uncertain or vague.

Examples of legitimate and recognized reasons for accumulations of earnings or profits, among others, would be:

(a) Provisions for bona fide expansion of the business.

(b) Acquiring a business enterprise to the purpose of stock or assets: and

(c) Provisions for cash, inventory, and other necessary working capital for the business.

(Tr. 514) In making your determination as to whether or not the executives of The Donruss Company retained earnings during either of the fiscal years ending January the 31st, 1960 or January 31st, 1961, for the purpose of avoiding taxes of its sole shareholder, Mr. Wiener, you must look at the matter from the viewpoint of the executives of the corporation and place yourselves in the position they occupied at the time and take into consideration all the facts and circumstances then existing and seek to determine what these executives intended at that time. Some of the factors which you may take into account when making this determination for the separate years here in question are the following:

1. Funds once distributed to the corporation shareholder and subjected to income tax in his hands at a higher tax bracket would no longer have been available for reinvestment in or use by this corporation.

2. A corporation may properly expand or modernize its plant and may legally do so by using its own assets for such growth or improvements rather than (Tr. 515) resorting to outside sources for additional funds.

3. In adopting the viewpoint and seeking to ascertain the intention or motivation of the executives of The Donruss Company with respect to that corporation's earnings for the years ending January 31st, 1960 and January 31st, 1961, you may ascertain whether those executives took into account potential tax liabilities or other contingent liabilities of the corporation in connection with their decision to retain the corporation's earnings for said period.

4. Comparative forces or factors in the gum and candy manufacturing industry, and particularly the size and financial condition of the competitors of The Donruss Company in that industry may be accepted by you as a proper reason for retaining quick assets in the business, if you find that during or at the end of the separate years in litigation here such competitive factors and the size and the condition of its competitors were considered by the executives of The (Tr. 516) Donruss Company when they decided to retain quick assets of the business during such years.

There are several ways, the Court instructs you by which a corporation may acquire the means of financing for its proper growth and expansion. It may issue additional capital stock. It may resort to bank loans. It may plow its earnings back into the business for immediate uses. It may, absent of any ulterior motives, accumulate its earnings until the expansion can be timely undertaken. All these methods are equally legitimate. There is nothing in the law which requires a corporate taxpayer to finance its expansion by borrowings from banks or by the sale of stock to outsiders. There is nothing in the law which prohibits a corporation from plowing its earnings back into the business for immediate uses or for accumulating its earnings until, as I say, expansion is timely, that is, unless such accumulation is for some ulterior purpose.

The Court instructs you that the reasonable needs of the business for which a corporation may properly accumulate its earnings includes investing money in a customer's business in order to maintain the business of the corporation. If you find in this case that the Directors (Tr. 517) of The Donruss Company during 1960 and 1961 honestly believed that acquiring stock of Tom Huston Peanut Company would enable The Donruss Company to maintain its large volume of sales to Tom Huston Peanut Company, and planned to buy such stock, when available, then you may consider whatever amount of its funds you find were retained during those years for the purpose of buying Tom Huston Peanut Company stock was retained for a reasonable business need.

Ladies and Gentlemen of the Jury, the Court instructs you that the directors or offficers of a corporation must, in Federal tax matters, be given some discretion and some latitude in deciding what constitutes the reasonable needs of the corporate business managed by them; the test of what the reasonable needs of a corporation may be, set up by Section 531 of the Internal Revenue Code, pertains only to the honest belief of a corporation's executives that the existing accumulation was no greater than was reasonably necessary: Another way of expressing this test is by saying that the accumulation of earnings or profits by a corporation is excessive when it exceeds the amount that a prudent businessman would consider appropriate for the present or the reasonably anticipated future needs of the business.

Members of the Jury, the mere possibility that earn- (Tr. 518) ings and profits will be used for a business purpose at some indefinite time in the future is not sufficient to make the accumulation reasonable.

To make the accumulation reasonable, the plans for expansion or conversion must have substance as an existing reality in the separate years here involved. The mere recognition of a future need is not sufficient under the law to justify an accumulation.

So, if you find from the evidence that The Donruss Company merely contemplated the possibility of future expansion, without any plan of substance in existence

during either of the fiscal years 1960 and 1961, the accumulation of earnings would appear unreasonable and the company must overcome the presumption that the accumulation was for the purpose of avoiding the shareholder's income taxes. In order to determine whether profits were accumulated for the reasonable needs of the business, or to avoid taxes of the shareholder, the controlling intention is that manifested at the time of accumulations not subsequently declared intentions which may be merely the products of afterthoughts. The intention must have been manifested by some course of conduct at the time of the accumulations.

(Tr. 519) In considering whether the accumulations for the corporation herein were unreasonable during the fiscal years in question, you should, as the Court has tried to make clear, consider whether the amounts of earnings and profits on hand at the beginning of each year in question were adequate for the reasonably anticipated needs of the business as seen at the end of each of the taxable years.

Consideration, Members of the Jury, you understand, should be given to reasonably anticipated needs as they existed at the close of a tax year. Subsequent events should not be used for the purpose of showing that the retention of earnings and profits was reasonable at the close of a tax year, if none of the elements of reasonably anticipated needs were present at the close of such tax year. Subsequent events, however, may be considered to determine whether the plaintiff in this case, The Donruss Company, actually intended to consummate any plans for which the earnings or profits were allegedly accumulated.

A corporate taxpayer may, if the Court has not already said so lawfully accumulate sufficient earnings and profits to provide against reasonably foreseeable business risks, and if you find from the preponderance of the evidence (Tr. 520) in this case, that any or all of the accumulations were for such purposes, such accumulations would not be subject to the imposition of any surtax or penalty.

A corporation, again as the Court has probably already stated, is not required by law to distribute all of its earnings even thought it may be able to borrow operating

capital for its present or foreseeable needs. If you find from a preponderance of the evidence that the earnings and profits in this case were accumulated with a reasonable anticipation of avoiding the necessity of borrowing in the future, such accumulations would not be subject to the imposition of any surtax or penalty.

Ladies and Gentlemen of the Jury, the Court instructs you that the directors and officers of the corporation are permitted in Federal tax matters, as here, some discretion and some latitude as to what constitutes the reasonably anticipated needs of the corporate business.

In resolving the question of whether the accumulated earnings in this case were retained for the reasonable business needs or the reasonably anticipated needs of the (Tr. 521) corporation for the fiscal years herein, the Jury may look to direct testimony which might throw light on the needs involved and to all other proved facts from which inferences may be drawn, tending towards support or rejection of contentions of the parties with respect to the ultimate facts in this case.

The Court instructs you that nothing in the law prohibits a corporate taxpayer from purchasing 50 percent of its stock held by one stockholder, if the acquisition of such stock is for the purpose of promoting harmony or efficiency of management of the corporation or to enable the corporation to continue its accustomed practices or policies. The acquisition of 50 percent of its outstanding stock from one stockholder by a corporation does not serve as any basis for the imposition of the penalty imposed by Section 531 and related sections of the Internal Revenue Code, unless you find that such acquisition was a planned tax avoidance device and that the earnings and profits of the business had been accumulated during some period prior to the acquisition by the corporation of one-half of its outstanding stock to give effect to the planned tax avoidance schemes.

(Tr. 522) As stated, Ladies and Gentlemen, the issues in this case arise under the Statutes that Congress has enacted which provide in substance that a corporation must pay a tax called accumulated earnings tax, if it does not distribute to its stockholders all accumulated earn-

ings in excess of what is reasonably needed by the business or in excess of the reasonably anticipated needs of the business.

The factual disputes between the parties of which you are the sole judge, may be presented to you in a number of ways. However, boiling the issues between the parties down, there remains three or four basic factual disputes with respect to the two years here in question, and the Court in this trial calls upon you jurors to resolve these disputes as follows:

First: What were the reasonable needs, or the reasonably anticipated needs of The Donruss Company for working capital to meet its normal business needs as of January 31, 1960 and January 31, 1961.

Second: As of January 31, 1960 and January 31,
(Tr. 523) 1961, did the Donruss Company have any fixed, definite, certain plans for expansion or diversification or the like that would require a retention of working capital in excess of the normal needs of its business?

Three: If you answered the last question in the affirmative, for either or both of the years under consideration, only then will you answer this question: What were the reasonable needs or reasonably anticipated needs of The Donruss Company for working capital, in excess of the working capital needed to meet its normal business needs, you understand, in order to finance fixed, definite, certain plans for expansion or diversification as of January 31, 1960 and January 31, 1961?.

Four: Was The Donruss Company during the years ending January 31, 1960 and January 31, 1961 availed of for the purpose of avoiding income tax liability of its sole shareholder, Mr. Donald Wiener?

(Tr. 524) Now, the Court has instructed you generally with respect to certain legal principles that you must apply in your consideration of this case and in answering each of the four questions mentioned by the Court.

Now, more specifically, in answering question number one with respect to the working capital requirements of The Donruss Company to meet its normal business needs, the Court instructs you that:

Working capital is the excess of The Donruss Company's current assets over liabilities. By this is meant that it is the excess of the aggregate of the cash, accounts receivable, inventory, and other current assets over the incurred liabilities which will have to be paid by The Donruss Company within one year.

You then determine the reasonable needs or the reasonably anticipated needs for working capital for the normal business needs of The Donruss Company. The words "reasonable needs" are used in the objective sense, that is, they mean what is reasonable to the average prudent and informed businessman. The words "reasonably anticipated needs" simply, of course, refer to the question as to what the management of The Donruss Company reasonably anticipated its needs for working capital to (Tr. 525) be for the years in question. If you find from the evidence that the management of The Donruss Company never considered or anticipated how much working capital they had to have for normal business needs for the years under consideration, then you are instructed that you must answer Question No. 1 with regard only to what the average prudent and informed businessman would consider working capital for normal business needs.

Working capital needs of a business will among other things depend upon the nature of the business, its credit policies, the amount of inventory and rate of the turnover, the amount of the accounts receivable, and the collection rate thereof, the availability of credit to the business, and similar relevant factors.

An accumulation of working capital for such things as unexpected demands of the business or unanticipated emergencies are unreasonable and cannot be considered by you in determining the reasonably anticipated working needs of The Donruss Company for working capital.

An important question here is whether in the light of the business needs of the corporation, it was reasonable to keep on hand the working capital it had as of January

(Tr. 526) 31st, 1960 and January 31st, 1961. In making up your minds about this, it is, of course, proper for you to review the conduct of the corporation during prior years and consider the financial history of the corporation.

The second and third questions you will be called upon to answer, you recall, have to do with whether The Donruss Company as of January 31st, 1960 and January 31st, 1961, had any fixed, definite, certain plans with respect to the expansion or diversifications that would require it to accumulate working capital in excess of its normal business needs, and if so, how much working capital was required? The Court, in this connection, instructs you:

First, it is important that you understand that we are talking about expansion and diversification, which is beyond and above the usual routine acquisitions of equipment and buildings that The Donruss Company has made regularly throughout its life.

To be more explicit, a business, if it is to continue, must constantly replace equipment as it wears out, and purchase additional equipment where it become available. Our tax laws in this connection permit a taxpayer to recover his costs of the assets rateably over their useful lives. In other words, if a taxpayer buys a piece of machinery (Tr. 527) chinery for $1,000 and the machinery will last three years, he is permitted under the law to depreciate one-third of value of the equipment in each of those three years. Over the three-year period, the taxpayer would receive a deduction, because of the consumption of the piece of equipment in the business operation. This concept of allowing a taxpayer a deduction over a period of time on the cost of the equipment is called depreciation. Under the concept of depreciation, which has been talked about in this case, a taxpayer is permitted to use any benefits therefrom in any manner he desires.

During The Donruss Company's years ending January 31st, 1960 and January 31st, 1961 it, as the Court understands from the proof, claimed and was allowed by way of depreciation aggregate amounts of $137,634.98 and $150,437.74, respectively, these amounts were not in-

cluded in the plaintiff corporation's accumulations of earnings and profit. These benefits, when claimed by the taxpayer, may be utilized by the taxpayer for replacement of plant equipment or may be held for expansion or diversification purposes, among other things.

As of the end of January, 1961, The Donruss Com- (Tr. 528) pany, it is contended by the defendant, could expect to recover similar depreciation deductions for future years in amounts in excess of $120,000 per year. Such deductions, as I say, could be utilized for replacement of equipment or other purpose of the corporate taxpayer.

So, on the subject of depreciation, the Court instructs you that you are to consider depreciation simply as another factor taken into account by the directors of The Donruss Company, when they decided to retain earnings as of January 31, 1960 and January 31, 1961. In that consideration of depreciation, you should determine from the testimony in the case what the viewpoint and belief of those directors was at such time concerning the depreciation.

The depreciation, according to the proof, claimed by The Donruss Company allowed in the years January 31, 1961, 1962, 1963 and 1964, as you will recall, was approximately $141,000 and $121,000, and $135,000 respectively.

So, it is necessary that you understand before attempting to answer Question No. 2 that each tax year in question The Donruss Company was allowed deductions as depreciation on equipment it owned and was free to take (Tr. 529) advantage of same as it saw fit in the operation of its business. The purpose of the depreciation allowance, to further explain, is to afford the owner of a wasting asset used in any trade or business, a means of recouping, tax-free, his investment in that property.

Question No. 2 refers to fixed, certain, definite plans. For there to be a fixed, certain, definite plan, it must be established by the evidence, in case it is not clear to you, that The Donruss Company had one or more specific requirements, plans or objectives in mind which required a reasonably definite amount of money. A nebulous plan

to expand or to invest in some future and indefinite time is not a fixed, certain, definite plan.

Definiteness of the plan coupled with action taken toward completion of the plan must be present as of January 31, 1960 and January 31, 1961 before it is possible to say that The Donruss Company had such definite plans.

Although The Donruss Company could not predict with certainty that its business could continue to increase, and that its earnings would continue as they had in the past, the fear of competition and fear of lack of liquidity, (Tr. 530) that is, having a lot of working capital, must be reasonable before they justify an accumulation of earnings and working capital. Businesses generally meet competition with like types of businesses, and must maintain their assets and equipment, but fear of competition alone, particularly when the business records of earnings in the past does not justify such fear, does not warrant accumulation of working capital and earnings. Likewise, reasonable businessmen realize that they might lose some existing customers and thus, sources of revenue. But this alone does not justify the accumulation of working capital and earnings.

You will notice that in stating Question No. 2, the Court uses the dates January 31, 1960 and January 31, 1961. The Donruss Company's fixed, definite, certain plans for expansion and diversification, if any, must, as the Court again reminds you, have been formulated as of those dates. The fact that The Donruss Company expended some of its working capital after January 31, 1960 or January 31, 1961 is not determinative. The critical and crucial facts are did The Donruss Company have definite, fixed, certain plans at each of these dates (Tr. 531) to make the expenditures in the future. If you find from the evidence that they did not have such plans, then as a matter of law, you must find that it was not reasonable to accumulate working capital and earnings for expansion, diversification, or the like.

In this case, The Donruss Company has the burden of proving that it contemplated expansion or diversification in excess of the routine replacement of equipment and it must also show that such was a real consideration as of

January 31, 1960 and January 31, 1961: And, as the Court has already pointed out in these instructions, not simply as an afterthought to justify the presence of the working capital and earnings.

You, Members of the Jury, are the sole judges of the facts surrounding this controversy, and in order for you to determine what the true facts are, you will be called upon to weight the testimony of all the witnesses who have appeared before you, giving to this evidence the weight, faith, credit and value you think it is entitled to receive. You will note the manner and demeanor of the witnesses on the witness stand, whether the witness impresses you as a witness who was telling the truth, or one who is not frank in his expression in answering questions: Consider the reasonableness or unreasonableness of the (Tr. 532) testimony of the witness: The opportunity or lack of opportunity of the witness for knowing the facts about which he testifies, his intelligence or lack of intelligence: The interest of the witness in the results of the trial, if any, and the relationship of the witness to either one of the parties litigant, if any. These are the rules which should guide you, along with your common experience, common observation, and common judgment in weighing the evidence introduced for you.

If there is a conflict in the evidence, it is your duty to reconcile the same, if you can, for the law presumes that every witness has attempted to testify to and has testified to the truth. But if you should find a conflict in the evidence and are unable to reconcile the same in accordance with these instructions, then it is with you absolutely to determine which ones of the witnesses, you believe, have testified to the truth and which ones you believe have testified falsely. Immaterial discrepancies do not affect the witness' testimony or credibility but material discrepancies do.

There are several methods of impeaching or discrediting a witness. One is to prove that a witness at different (Tr. 533) times made conflicting statements as to the material facts in the case as to which he testified. Another method is by rigid cross-examination to involve the witness in contradictions and discrepancies as to the ma-

terial facts stated by him. Immaterial discrepancies in statements of witnesses do not affect their credibility unless there is something to show that they originate in wilful falsity. And you, Members of the Jury, are to determine how far the testimony of any impeached witness in this case has been impaired by either of these invalidating processes is the question to be decided by the Jury like all other questions of fact.

The issues in this case and the respective contentions of the parties are evidence enough, the Court feels sure. If you find that the plaintiff corporation did accumulate earnings beyond a reasonable present or current needs of its business, or its reasonably anticipated business needs, for the fiscal years ending January 31, 1960 and 1961, and you further find that the purpose of such accumulation was to avoid payment of taxes by the sole shareholder of the plaintiff corporation, Mr. Wiener, then your verdict for each year herein should be for the defendant, The United States of America.

(Tr. 534) On the other hand, if you find by a preponderance of the evidence that the accumulation of earnings and profits by the plaintiff corporation, as aforesaid, was for the plaintiff corporation's reasonable current or anticipated business needs, and was not for the purpose of avoiding payment of individual tax by its shareholder, Mr. Wiener, then your verdict, or verdicts, would be for the plaintiff in this case.

Now, Ladies and Gentlemen of the Jury, the Court has stated briefly the contentions of the parties with respect to this litigation. Their contentions have been set up in the pleadings, which have been explained to you, and issues made and argued to you by counsel, and it is now for you to say under these controverted issues where the weight of the evidence lies. Bear in mind, as the Court has said, that it is the duty of the plaintiff taxpayer to show by the greater weight or preponderance of the evidence of the earnings herein for the separate fiscal years were accumulated for the purpose of meeting the reasonable current business needs or reasonably anticipated business needs of the plaintiff corporation herein and not

for the purpose of avoiding additional personal tax with respect to its lone shareholder.

(Tr. 535) If, Ladies and Gentlemen of the Jury, after a careful consideration of the evidence in the case and the instruction here given you by the Court, you find that the plaintiff taxpayer has shown by the proper quantum of proof, that is, by the greater weight or preponderance of the evidence, that the earnings here in question for the two years under consideration, were accumulated for the purpose of meeting the reasonable business needs or reasonably anticipated business needs of the plaintiff, The Donruss Company, herein, rather than for the purpose of avoiding taxes with respect to its sole shareholder, Mr. Wiener, you will find for the plaintiff, for each year, and report to the Court accordingly.

If, on the other hand, you find that the earnings were not accumulated for the corporation's reasonably current or anticipated business needs, but for the purpose of avoiding personal income taxes with respect to its sole shareholder, Don Wiener, you will, in that event, find for the defendant, The United States of America and report verdicts in its favor.

At times, Ladies and Gentlemen, throughout the trial the Court has been called upon to pass on the question of whether or not certain evidence might be properly admitted. With such rulings and the reasons for them you (Tr. 536) are not concerned. Whether offered evidence is admissible is purely a question of law and from a ruling of such question you are not to draw any inference as to what weight should be given the evidence or as to the credibility of a witness.

In admitting evidence to which an objection was made the Court does not determine what weight should be given such evidence. As to any offer of evidence that was rejected by the Court, you, of course, must not consider the same. As to any question to which an objection was sustained, you must not conjecture as to what the answer might have been or as to the reasons for the objection.

In an effort to be helpful, Ladies and Gentlemen, the Court suggests the attitude or conduct of jurors at the outset of their deliberation as matters of considerable im-

portance. It is not discreet for a juror upon entering the jury room to voice emphatic expressions of his opinion of the case or to announce his determination to stand for a certain verdict. When one does that at the outset his sense of pride may cause him to hesitate to recede from an announced position if and when shown that it is fal- (Tr. 537) lacious. Remember that you are not partisans or advocates in this matter but are in reality judges. The final test of the quality of your service will ride in the verdict or verdicts which you return to this courtroom, not in the opinions any of you may hold as you retire. Bear in mind that you will make a definite contribution to efficient judicial administration if you arrive at a just and proper verdict in this case. To that end, the Court reminds you that in your deliberations in the jury room there can be no triumph other than the ascertainment and declaration of the truth.

Preliminarily to your being accepted and sworn as jurors in this case you were examined by counsel for both the Government and the defendant as to your competency and qualifications to act as jurors in this case. As a part of such examination, each of you answered all questions asked by counsel. Your answers showed that you were competent and qualified to act as jurors in this case, and the parties accepted you as jurors on the face of your answers. The answers you then made to said questions in regard to your competency, qualifications, fairness, lack of prejudice and freedom from passion and sympathy are as binding on you now as they were then and should (Tr. 538) so remain until you are finally discharged from further consideration of this case. It would be improper for you to disregard the answers that rendered you competent as jurors.

Ladies and Gentlemen of the Jury, appropriate forms in the nature of interrogatories will be furnished you in the jury room, upon which you may indicate your decisions concerning these matters.

Any answer that you give to the interrogatories should be signed by a foreman selected by you after you retire to the jury room and, of course, your answers must be unanimous agreement. You should not agree to any an-

swer through a gambling or speculative process. Considerations of prejudice or sympathy should not enter into your deliberations one way or another.

In considering your answers to the interrogatories, you are not to single out any certain parts or any particular point, or instructions, and ignore the others, but you are to consider all of the Court's instructions as a whole and to regard each in the light of all the others.

* * * *

REFUSAL TO CHARGE DEFENDANT'S REQUESTED INSTRUCTION NO. 15

"Defendant's Requested Instruction No. 15

Refused—Boyd, J.
2-18-65

"The Court instructs you it is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings; it is sufficient if it is one of the purposes for the company's accumulation policy."

* * * *

INTERROGATORIES

1. Did plaintiff corporation permit its earnings or profits for the following years to accumulate beyond the reasonable or reasonably anticipated needs of its business?

Year ended January 31, 1960 Yes √ No_____
Year ended January 31, 1961 Yes √ No_____

2. Were such accumulations retained by plaintiff corporation for the purpose of avoiding the income tax on its stockholder, Don Wiener?

Year ended January 31, 1960 Yes_____ No √
Year ended January 31, 1961 Yes_____ No √

/s/
....
Foreman

This 19th day of February, 1965.

JUDGMENT

This cause came on for trial before the Honorable Marion S. Boyd, Judge, and a jury at Court held in the City of Memphis on the 15th day of February, 1965.

And it appearing that the two principle issues in this cause, which, if either were decided favorably to plaintiff, would be the only issue in this cause, were whether or not the earnings of the Donruss Company had been permitted by that corporation to accumulate for the year ended January 31, 1960 or for the year ended January 31, 1961 beyond the reasonable or the reasonably anticipated business needs of that corporation and, secondly, whether or not the corporation, the Donruss Company, was availed of for the purpose of avoiding the income tax on its stockholder, Don Wiener, for the fiscal year ended January 31, 1960 or the fiscal year ended January 31, 1961.

And it further appearing that the said questions of fact were submitted to the jury in the form of interrogatories, agreed upon by counsel for both parties, which interrogatories and the answers made thereto by the jury were in words and figures, as follows:

> "1. Did plaintiff corporation permit its earnings or profits for the following years to accumulate beyond the reasonable or reasonably anticipated needs of its business?
>
> Year ended January 31, 1960 Yes x No_____
> Year ended January 31, 1961 Yes x No_____
>
> 2. Were such accumulations retained by plaintiff corporation for the purpose of avoiding the income tax on its stockholder, Don Wiener?
>
> Year ended January 31, 1960 Yes_____ No x
> Year ended January 31, 1961 Yes_____ No x

/s/ W. Gordon Morris
Foreman

This 19th day of February, 1965."

And it further appearing that the plaintiff is entitled to judgment on said verdict of the jury.

And it further appearing that on or about April 30, 1962 plaintiff paid an alleged tax deficiency assessed against it under Section 531 et seq. of the Internal Revenue Code of 1954 with respect to its year ended January 31, 1960 in the amount of $24,653.52 and interest thereon in an amount to be determined by defendant and further that on said date plaintiff paid an alleged tax deficiency assessed against it under said Code Section in the amount of $10,499.39 and interest thereon in an amount to be determined by defendant with respect to plaintiff's taxable year ended January 31, 1961.

It is, therefore, ORDERED, ADJUDGED AND DECREED: That plaintiff, the Donruss Company, a corporation, have and recover of defendant assessed tax for 1960 and 1961 in the total amount of $35,152.91 plus interest paid thereon by plaintiff April 30, 1962, as may be determined by defendant, plus interest as allowed by law on said tax and interest from the date of payment thereof by plaintiff, April 30, 1962.

MARION S. BOYD
Judge

DATE: 3/3/65

APPROVED:

TOM MITCHELL, JR.
Attorneys for Plaintiff

A TRUE COPY.

ATTEST:

W. LLOYD JOHNSON, Clerk
By V. LAFON, D.C.

AMENDMENT TO JUDGMENT

By consent of the parties, as evidenced by the signature below of attorneys for same, the judgment heretofore entered in this cause March 3, 1965 is amended by the following addition thereto. This addition is made pur-

suant to the language in said judgment that interest paid upon taxes assessed against plaintiff for 1960 and 1961, "as may be determined by defendant" would be recoverable by plaintiff. Defendant has now determined and computed the amount of such interest. That computation as part of a schedule entitled "Summary Statement" is attached hereto and made part hereof as Exhibit 1.

Pursuant to the attached computation and by agreement between the parties hereto,

It is ORDERED, ADJUDGED AND DECREED:

1. That plaintiff shall have and recover of defendant interest assessed against and paid by plaintiff with respect to additional taxes for its fiscal year ended January 31, 1960 in the amount of $2,978.68.
2. Plaintiff shall have and recover of defendant interest assessed against and paid by plaintiff with respect to additional taxes for its fiscal year ended January 31, 1961 in the amount of $638.59.
3. Plaintiff is entitled to have and recover of defendant refund of additional taxes for its fiscal year ended January 31, 1960 and January 31, 1961, plus interest paid by plaintiff thereon, in the total amount of $38,770.18 plus interest on the said total $38,770.18 from April 30, 1962 at the rate of six (6%) per cent according to law.

MARION S. BOYD
Judge

DATE: March 11th, 1965

APPROVAL AND CONSENT

TOM MITCHELL, JR.
Attorneys for Plaintiff

UNITED STATES OF AMERICA

By: THOMAS L. ROBINSON

A TRUE COPY.
ATTEST:

W. LLOYD JOHNSON, Clerk
By W. LLOYD JOHNSON

MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT AND IN THE ALTERNATIVE FOR A PARTIAL NEW TRIAL

Defendant, by and through Thomas L. Robinson, United States Attorney for the Western District of Tennessee, moves the Court to enter an order setting aside the jury's answer to the special interrogatories rendered herein on February 19, 1965, and entering a judgment for defendant in accordance with defendant's motion for a directed verdict at the conclusion of plaintiff's case, and the renewal thereof at the conclusion of all of the evidence, particularly upon the following ground:

1. Since Don Wiener knew he would have to pay income tax on any dividends paid to him by plaintiff during the plaintiff's fiscal years ending January 31, 1960, and January 31, 1961, and since Don Wiener was actively engaged in directing the business affairs of plaintiff, such knowledge must be imputed to the plaintiff corporation. Once this is established, as it is in this case, viewing all of plaintiff's evidence in a light most favorable to it, and resolving all of the conflicts in the evidence in plaintiff's favor, reasonable men could not differ in reaching the conclusion that the failure of Donruss Company to pay dividends was for the purpose of avoiding the income tax of Don Wiener regardless of what other purposes for accumulating plaintiff's earnings it may have established. In other words, even without weighing the credibility of the witnesses, there can be but one reasonable conclusion as to the verdict of whether the purpose of plaintiff's accumulation of earnings was to avoid the income tax of Don Wiener, regardless of what other purposes for the accumulation plaintiff may have established.

* * * *

3. Defendant was substantially prejudiced at the trial of this case because of each and the aggregate of all the errors made by the Court, as follows:

* * * *

(g) The Court submitted Special Interrogatory No. 2 to the jury, using the language, "Were such accumulations retained by plaintiff corporation for the purpose of avoiding the income tax on its stockholder Don Wiener?" Defendant objected to the general charge upon the grounds that it was error as a matter of law to submit such interrogatory to the jury without qualifying and explaining in the instructions that "the purpose" to avoid income tax need not be the dominant or the sole purpose, but it was sufficient if it be one of several purposes. Defendant also requested the Court to give an instruction to this effect. (Defendant's Requested Instruction No. 15.)

* * * *

WHEREFORE, it is prayed (1) that the Court enter a judgment notwithstanding the verdict in favor of the defendant, and (2) in the alternative, that the Court grant defendant a partial new trial on the issue of whether the unreasonable accumulations were for the purpose of avoiding Don Wiener's income tax, or, if the Court determines that it is not possible to grant a partial new trial, a new trial on all issues.

UNITED STATES ATTORNEY

* * * *

HEARING ON MOTION FOR JUDGMENT N.O.V. AND IN THE ALTERNATIVE FOR A PARTIAL NEW TRIAL

(Tr. 580) THE COURT: All right, Mr. White, we will hear your Donruss motion.

That jury is not ready to report?

THE MARSHAL: No, sir.

THE COURT: I was about to say the Court has read your motion and I think is on speaking terms with this matter. But go ahead. We will be glad to hear you.

MR. WHITE: I am sorry. I thought the Court was going to take a report from the jury.

THE COURT: No, I was just inquiring. I got the impression the jury was going to report when the Marshal brought in one of the prisoners.

MR. WHITE: Your Honor, at the outset I would like (Tr. 581) to make a preliminary remark about the instructions the Court gave the jury before talking about the motion. Your Honor will remember the second interrogatory Your Honor submitted asked them were the accumulation of Donruss earnings for the purpose of avoiding the income taxes for the sole shareholder, Mr. Wiener. And we objected to the Court's general charge to the jury after the charge was given, upon the grounds that the Court failed to go forward to explain to the jury that answering this second interrogatory, they should answer "yes," or they should find that the accumulation was for the purpose of avoiding income tax if from the evidence they could discern that one of the reasons for this accumulation was to avoid the income tax. In other words, it did not have to be the sole reason. But if the Donruss Company had ten or twenty reasons for the accumulation and one of the reasons was for the avoidance of income tax—

THE COURT: Well, didn't the Duke—I believe it (Tr. 582) was the Duke case—come into the picture about that?

MR. WHITE: Well, in the Duke case, Your Honor the same interrogatory was given the jury up in Connecticut as you now gave the jury in this case, but that

Court went on to clarify and explain that it is not the sole purpose but it is sufficient if it is one of the purposes.

THE COURT: Well, what other purpose could there have been in this lawsuit?

MR. WHITE: For the accumulation, sir?

THE COURT: Yes, What other purpose? What is in the evidence?

MR. WHITE: Well, I think that the witness testified that he had talked about buying some stock in the Tom Huston Company. And that perhaps is also one of the purposes for the accumulation. And they were afraid of competition. Perhaps that is one of the reasons.

THE COURT: Well, that all merges into the main question, doesn't it?

(Tr. 583) MR. WHITE: Well, I think that the principal question is whether the accumulation was unreasonable. And the jury found the accumulation is unreasonable, taking into consideration all matters that the company planned or stated.

But as to the second question, what might probably have caused them on it some question—and the second question "Was the accumulation for the purpose of avoiding the tax of the Donruss Company?" That is, did plaintiff, Donruss Company—if they could have some purpose in addition to avoidance of income tax, that they are home free insofar as income tax law.

THE COURT: There are many of these things that have slipped the Court's mind, but it just seems to the Court the Duke case pretty well settled this. They were construing the regulations, I believe, in that case.

MR. WHITE: In the Duke case, Your Honor, the exact—

THE COURT: That is—

(Tr. 584) MR. WHITE: The exact question that this Court asked this jury in the Duke case was asked. But the Court in the Duke case went on to explain that if the jury found that this corporation, Duke Laboratories, had several purposes, and one of the many purposes was the avoidance of income taxes, then they had to answer that interrogatory "Yes." In other words, it is not one purpose, but if it is one of many purposes, you see. I assume—

THE COURT: Well, actually, are there any other purposes that there could have been involved here? I just can't—. This was the only question and nothing that I might—

MR. WHITE: Well, Your Honor, I think that the witnesses for the Donruss Company testified on several occasions that they had prospects of buying Tom Huston stock, for instance, and they had talked about it, and that would justify perhaps the accumulation. And if in the proceeding and instruction—and we asked the Court to (Tr. 585) instruct the jury if they answered the Court's interrogatory without these qualifications, if the jury found that the Donruss Company had any other reason other than the avoidance of income taxes for this accumulation, the jury had to answer that question the way they did. But that if the Court—we believe if the Court had instructed the jury that if the Donruss Company had twenty reasons for the accumulation and any of those twenty was for avoidance of tax, then they had to answer that question—.

THE COURT: Well, I don't believe there is anything to that.

Go ahead, then, to something else. I did put up the question to them pretty squarely, I thought. I explained the issues. But go ahead. Let me hear you.

MR. WHITE: No, I am pleased, sir, because this is one of the real crucial points in our argument. But we assume that this statement is an accurate statement of the law, Your Honor.

(Tr. 586) And I was just looking for the Duke Laboratories—I had some language from the instruction in the Duke Laboratories case, to point out to the Court that this Court did not give such an instruction.

This is what the Court of Appeals in the Duke Laboratories case said:

> "Courts should have some reluctance in rewriting statutes. The Congress did not use the article "a" in sections 532 or 533. It did not choose to employ "any" or "dominant" or "primary" purpose. A finding that the accumulations were beyond the reason-

able needs of the business was to "be determinative of the purpose to avoid" unless the taxpayer "by the preponderance of the evidence shall prove to the contrary."

Then the Court comments on the point I am trying to make here:

"The jury was mislead, the Government claims, by (Tr. 587) "the" in the second question."

The Court says this:

"Analysis of the Court's instructions to the jury dispels any such inference. The jury was told that the taxpayer had the burden "to show by a preponderance of the evidence the absence of any intent to avoid the income tax with respect to its shareholders, regardless of whatever other purposes for accumulation the plaintiff may have established."

And then this Court goes on to point out that, as a matter of law, if the interrogatory is given to the jury in the fashion that this Court gave the Donruss jury the interrogatory, that interrogatory has to be explained, has to be qualified in the instructions to the effect that if the jury should find that one of the many purposes was avoidance of tax, then that they must answer the question—

THE COURT: Well, we tried this lawsuit on the one (Tr. 588) purpose theory. I think we did, didn't we? Mr. Burch, did we do that or not?

MR. BURCH: All or one, if Your Honor please?

THE COURT: However —

MR. BURCH: Yes, sir, all or none, is the way we tried it from the start.

THE COURT: I thought so. I may be in error about it. And I still can't see where there was anything in the proof by which the jury—you did mention the Tom Collins—

MR. WHITE: Huston, Your Honor.

THE COURT: —Tom Huston matter. Then specifically charged the jury with respect to that transaction and told them they could consider that on the question as to whether that—as a part of it.

MR. WHITE: Well, Your Honor, as I understand the way the Court submitted the case to the jury, if the jury would find that one of the purposes for this accumulation —one of the reasons for the accumulation was the pur- (Tr. 589) pose to buy this Tom Huston stock, then, as a matter of law, they had to answer the interrogatory the way they did. In other words, we believe if the Donruss Company had ten reasons for the accumulation, and one of the ten reasons was to avoid the tax of Don Wiener, then the jury should answer that interrogatory "yes." Plaintiff says if they can show any reason other than the avoidance of income tax, the jury should have answered "no." That is a matter of law.

And, Your Honor, we rely on that statement of law in our motion for judgment NOV. And, upon the assumption that the statement is an accurate statement of the law, we believe we are entitled to judgment NOV for the following reasons: As a matter of law and as a matter of fact in this case, the Donruss Company had actual knowledge that it was avoiding the income tax of Don Wiener by not paying dividends but permitting accumulations to build up as they did. In other words, the corporation we say was placed in the state of mind of actual (Tr. 590) knowledge that they were avoiding income tax. Now, with respect to the burden of proof in the case, the Donruss Company, as all plaintiffs in tax litigation, or as all plaintiffs in general litigation, had the burden of proving their case by the preponderance of the evidence. But in a 531 case like this, there is a little quirk with regard to the burden of proof. And the Donruss Company in the circumstances of this case is required to prove a negative, the circumstances being that the jury return a finding that it was an unreasonable accumulation.

Now, the fact that it was such unreasonable accumulation, according to the statute, "shall be determinative of the second issue", to-wit, what was the purpose for the accumulation. And the statute referred to states that it shall be determinative unless plaintiff proves by a clear preponderance of the evidence that the unreasonable accumulation was not for the purpose of avoiding taxes.

(Tr. 591) So we believe that this extraordinary burden of proof was demanded as a result of the jury's finding on the first interrogatory, and that actually, the Donruss Company had the burden of proving a negative, which we think was never done here. In other words, we believe that the evidence in the case, from the witnesses, from the documents, when coupled with this actual state of mind, that is, knowing—the knowledge of the Donruss Company that it was avoiding Don Wiener's tax, coupled with the fact that the Donruss Company had to prove a negative—those three things, when put together, and viewing all the evidence in the light most favorable to the plaintiffs and resolving all conflicts in the evidence in favor of plaintiffs, we believe that reasonable men would all contend that this accumulation had as one of its purposes the avoidance of Don Wiener's income tax.

Now, plaintiffs object on three bases—only three bases (Tr. 592) or reasons to the conclusion that we are entitled to a judgment NOV. Their three bases are as follows:

With respect to the first proposition or matter that I took up in the preliminary remarks—I have already talked about this—they say that if they could establish one reason for the accumulation other than the avoidance of tax, then the jury verdict is proper. And we say that if one of the hundreds of reasons for the accumulation was avoidance of tax, then the jury verdict is improper because the plaintiffs have not negated all those things.

The second reason is, plaintiffs say that "We never had the burden of proving a negative in this case." They say that there is nothing more than the normal burden of proof on them. We say, of course, that the statute demanded it.

THE COURT: Well, the Court put the proper burden on them, didn't it?

MR. WHITE: The instructions, yes, Your Honor, you (Tr. 593) correctly stated the point that they had the burden of proving a negative. And the plaintiffs have said that they don't have such a burden. And they cite this Tax Court case. And of course there, as the Court

is aware, the Tax Court rule with regard to the burden of proof in a 531 case is completely different. The rule in the Tax Court places the burden in a 531 case on the Government. And this Tax Court case that is cited by plaintiffs in support of their contention that our proposition was incorrect is discussing—that Casey case is discussing the Tax Court burden of proof.

And finally, they make an observation with regard to our position that the Donruss Company had actual knowledge that they were avoiding Don Wiener's tax. They say—plaintiff says that that is true in every 531 case. Well, it is not true in every one of them. It is only true in your 531 cases where the taxpayer shareholder is also the person who manages the corporation, as here.
(Tr. 594) What we are trying to argue for with regard to that proposition is that the Donruss Company had actual knowledge that it was avoiding the shareholder's tax.

So, Your Honor, on those grounds that we have just stated, we believe that we are entitled to judgment NOV and that the Court should enter a judgment in the Government's favor, despite the jury's response to the second interrogatory here.

Now, would the Court desire for me to proceed to discuss the alternative motion at this time, Your Honor please?

THE COURT: Yes, sir, I think so.

MR. WHITE: In the alternative, we move the Court for a partial new trial on the second interrogatory because—that is, whether the accumulation was for the purpose of avoiding the Donruss Corporation's tax, and in the alternative we ask the Court for a whole new trial upon both issues, if the Court is not merely granting a partial new trial.

* * * *

ORDER OVERRULING DEFENDANT'S MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT AND IN THE ALTERNATIVE FOR A PARTIAL NEW TRIAL

This cause came on to be heard on the 2nd day of April, 1965 upon the written Motion for Judgment Notwithstanding the Verdict and in the Alternative for a Partial New Trial of defendant in the subject cause, notice of said motion to attorneys for plaintiff herein, and the entire record in this cause, from all of which it appears to the Court that said motion and each and every count thereof is without merit and that said motion should in all things be overruled.

It is, therefore, ORDERED, ADJUDGED AND DECREED that the defendant's Motion for Judgment Notwithstanding the Verdict and in the Alternative for a Partial New Trial in this cause be and the same is hereby overruled.

All of which is ORDERED, ADJUDGED AND DECREED this ____ day of April, 1965.

/s/ MARION ~~S.~~ BOYD
Judge

APPROVED AS TO FORM:

/s/ THOMAS L. ROBINSON
United States Attorney

/s/ TOM MITCHELL, JR.
Attorney for Plaintiff

A TRUE COPY.

ATTEST:

W. LLOYD JOHNSON, Clerk
By V. LAFON, D.C.

* * * *

NOTICE OF APPEAL

Notice is hereby given that the United States of America, defendant, hereby appeals to the United States Court of Appeals for the Sixth Circuit, from the Order Overruling Defendant's Motion For Judgment Notwithstanding The Verdict And In The Alternative For a Partial New Trial, which was entered in this action on April 2, 1965.

This May 28, 1965.

/s/ THOMAS L. ROBINSON
United States Attorney

* * * *

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 16788

THE DONRUSS COMPANY, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Appeal from the U.S. District Court for the Western District of Tennessee

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Decided September 27, 1967

Before: O'SULLIVAN and CELEBREEZE, Circuit Judges, and BATTISTI, District Judge.*

BATTISTI, District Judge. The Commissioner of Internal Revenue assessed and collected from appellee, The Donruss Company (hereafter Donruss), accumulated earnings taxes for the taxable years 1960 and 1961.

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* Honorable Frank J. Battisti, United States District Judge for the Northern District of Ohio, sitting by designation.

Thereafter, Donruss brought an action for the refund of said taxes in the District Court for the Western District of Tennessee. On the basis of a jury's responses to special interrogatories, the District Court entered judgment for Donruss. The United States appeals.

The interrogatories which were submitted to the jury, and the responses thereto, are as follows:

"1. Did plaintiff corporation permit its earnings or profits for the following years to accumulate beyond the reasonable or reasonably anticipated needs of its business?

	Answer
Year ended January 31, 1960	*Yes*
Year ended January 31, 1961	*Yes*

"2. Were such accumulations retained by plaintiff corporation for the purpose of avoiding the income tax on its shareholder, Don Wiener?

	Answer
Year ended January 31, 1960	*No*
Year ended January 31, 1961	*No* "

In this appeal the Government does not specifically question the propriety of the above-quoted interrogatories. Rather, it urges that the portion of the District Court's general charge explaining the principles underlying the same was misleading and incorrect.

Section 531 of the Internal Revenue Code of 1954 imposes an accumulated earnings tax on every corporation which, as described in Section 532, is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders * * *, by permitting earnings and profits to accumulate instead of being divided and distributed." Section 533(a) provides that where earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business, this fact "shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."

The ultimate question in every accumulated earnings tax case is not whether earnings and profits have been accumulated beyond the reasonable needs of the business but whether they have been accumulated for the purpose of avoiding income tax with respect to shareholders. While the reasonableness or unreasonableness of an accumulation is a most significant factor to be considered, particularly with regard to the Section 533(a) presumption, it is not necessarily determinative of the ultimate question, that is to say, whether the corporation was availed of for the proscribed purpose. In *United States* v. *R. C. Tway Coal Sales Co.*, 75 F. 2d 336 (1935) at p. 337, this court said:

> "It is the accumulation of surplus plus its interdicted purpose that brings the statute into operation, and its size in relation to business needs is but a circumstance out of which a presumption of improper purpose arises, though such purpose may be shown by pertinent evidence with or without the presumption as an aid. This view is undoubtedly that of the Court of Appeals of the Second Circuit in *United Business Corp.* v. *Commissioner*, 62 F. 2d 754, 755, and may be accepted as sound. The practical application of the interpretation may, however, in most circumstances be of little importance. The condemned purpose in the forming or utilization of corporations described in the section is the avoidance by stockholders of surtaxes. This purpose may be proved unaided by presumption, but the fact that surplus is not unreasonably large in respect to the needs of the corporation's business is repugnant to the existence of such purpose, and, while not conclusive, must be accepted as substantial evidence in denial of proofs or inferences that it exists."

Thus, if the proscribed purpose is present, the accumulated earnings tax may be imposed even though the accumulation is reasonable. *United States* v. *R. C. Tway Coal Sales Co.*, *supra*; *Whitney Chain & Mfg. Co.* v. *Commissioner*, 149 F. 2d 936 (C.A. 2 1945); *Pelton Steel Casting Co.* v. *Commissioner*, 251 F. 2d 278 (C.A.

7 1958). On the other hand, if the proscribed purpose is not present, the accumulated earnings tax may not be imposed notwithstanding an unreasonable accumulation. *Duke Laboratories, Inc.* v. *United States*, 337 F. 2d 280 (C.A. 2 1964).

In urging that the District Court's charge was erroneous and misleading, the Government has alluded to certain portions thereof wherein the court discussed the factors which the jury could take into consideration in determining whether earnings and profits were accumulated to meet the "reasonable needs of the business." However, since the jury concluded that the earnings and profits were not accumulated to meet the reasonable needs of the business, any error in this regard would not constitute prejudicial error.

The Government also urges that the charge was erroneous and misleading in that it could have led the jury to conclude that if the accumulations were reasonable there could be no purpose to avoid the tax or, conversely, that if the accumulations were unreasonable the tax should be imposed. For example, the court charged the jury as follows:

> "As stated, Ladies and Gentlemen, the issues in this case arise under the Statutes that Congress has enacted which provide in substance that a corporation must pay a tax called accumulated earnings tax, if it does not distribute to its stockholders all accumulated earnings in excess of what is reasonably needed by the business or in excess of the reasonably anticipated needs of the business." (TR 522)

* * * *

> "If, Ladies and Gentlemen of the jury, after a careful consideration of the evidence in the case and the instruction here given you by the Court, you find that the plaintiff taxpayer has shown by the proper quantum of proof, that is, by the greater weight or preponderance of the evidence, that the earnings here in question for the two years under consideration, were accumulated for the purpose of meeting the reasonable business needs or reasonably

anticipated business needs of the plaintiff, The Donruss Company, herein, *rather than* for the purpose of avoiding taxes with respect to its sole shareholder, Mr. Weiner, you will find for the plaintiff, for each year, and report to the Court accordingly." [Emphasis supplied] (TR 535)

When the above-quoted portions of the District Court's charge are read out of context they seem to indicate that the ultimate question the jury was called upon to resolve was whether the accumulations were reasonable or unreasonable. While that would not correctly represent the applicable law, it should be noted that the Government did not object to the charge in that regard, although numerous exceptions were specifically and articulately entered. It is also notable that in various other portions of the charge the District Judge correctly stated the applicable law. For example, the court instructed the jury:

"If you find any of the earnings and profits of the plaintiff for a given year in question were allowed to accumulate beyond the reasonable needs of the business, for that particular year, this shall be determinative of the purpose to avoid the income tax with respect to its sole shareholder, for that year, unless, of course, as the Court has said, that the taxpayer proves the contrary by a preponderance of the evidence." (TR 511)

* * * *

"The issues in this case and the respective contentions of the parties are evidence enough, the Court feels sure. If you find that the plaintiff corporation did accumulate earnings beyond a reasonable present or current needs of its business, or its reasonably anticipated business needs, for the fiscal years ending January 31, 1960 and 1961, and you further find that the purpose of such accumulation was to avoid payment of taxes by the sole shareholder of the plaintiff corporation, Mr. Weiner, then your verdict for each year herein should be for the defendant, The United States of America." (TR 533)

Under Rule 51 of the Federal Rules of Civil Procedure a party who fails to raise a particular objection is deemed to have waived the same. *Transamerica Freight Lines, Inc., et al.* v. *Universal Die Casting Co.*, 192 F. 2d 931 (C.A. 6 1951); *The Sucher Packing Co.* v. *Manufacturers Casualty Insurance Company*, 245 F. 2d 513 (C.A. 6 1957); *McPherson* v. *Hoffman*, 275 F. 2d 466 (C.A. 6 1960); *Solomon* v. *United States*, 276 F. 2d 669 (C.A. 6 1960); *Waxler* v. *Waxler Towing Co.*, 342 F. 2d 746 (C.A. 6 1965). Viewing the District Judge's charge as a whole we are unable to say that the portions quoted above so misled the jury that an abrogation of this principle is warranted. Certainly the fact that able counsel for the Government chose not to object to the same strongly indicates that the charge as a whole did not, as the Government now urges, mislead the jury with regard to a most fundamental question.

Throughout his charge the District Judge instructed the jury that they were required to determine whether Donruss was availed of for "the" purpose of avoiding income tax with respect to its shareholder. At no point during his charge did the District Judge explain to the Jury the significance or meaning of the word "the" as used in the phrase "availed of for the purpose of avoiding income tax." At the conclusion of the charge the Government objected to the same on the ground that the court's failure to so explain the significance or meaning of the word "the" could have led the jury to conclude that avoidance of tax must be the sole purpose behind an accumulation. The Government also objected to the court's failure to give the following Special Request for Instruction:

> "The Court instructs you it is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings; it is sufficient if it is one of the purposes for the company's accumulation policy."

In the face of the Government's objections the District Judge refused to give any clarification as to the meaning of the phrase "the purpose."

In our view, Sections 531-535 cannot reasonably be construed to require that the purpose to avoid income tax be the sole purpose behind an accumulation before the additional tax may be imposed. Rather, the critical question appears to be whether these sections require that tax avoidance be the dominant, controlling, or impelling purpose behind an accumulation rather than simply "a" purpose. In this regard the authorities differ. In *Trico Products Co.* v. *Commissioner*, 137 F. 2d 424 (C.A. 2 1943) the court stated at p. 426:

> "Nor can we subscribe to the view that the prevention of the imposition of surtaxes must have been shown to have been the dominant factor behind the accumulations."

A similar conclusion was reached in *Barrow Mfg. Co.* v. *Commissioner*, 294 F. 2d 79, 82 (C.A. 5 1961):

> "The Tax Court found, in the language of the statute, that petitioner was availed of 'for the purpose of preventing the imposition of the surtax upon its shareholders.' There was no error in failing to go further and find that that was the primary or dominant purpose of the accumulation. See *Young Motor Co.* v. *Commissioner*, 1960 1 Cir., 281 F. 2d 488, 491. Compare *Kerr-Cochran, Inc.* v. *Commissioner*, 8 Cir. 1958, 253 F. 2d 121, 123. Judge Learned Hand has called attention that this statute 'stands on the footing of the participants' state of mind,' viz., 'the *purpose* of preventing the imposition of the surtax upon its stockholders,' and that it may need the support of presumption, indeed be practically unenforceable without it. * * *' *United Business Corporation* v. *Commissioner*, 2 Cir., 1933, 62 F. 2d 754, 755. The utility of the badly needed presumption arising from the accumulation of earnings or profits beyond the reasonable needs of the business is well nigh destroyed if that presumption in turn is saddled with requirement of proof of 'the primary or dominant purpose' of the accumulation."[1]

[1] See also, *Mertens*, Section 39.26 and cases cited therein.

The First Circuit reached an opposite conclusion in *Young Motor Co. v. Commissioner*, 281 F. 2d 488, 491 (C.A. 1 1960):

"The Tax Court may have been led into this error by a misconception of the precise issue. In its opinion it referred to preventing the imposition of the surtax upon stockholders as 'one' of taxpayer's purposes, and stated, 'If this purpose exists it may be accompanied by other legitimate business objectives and still the statute will apply.' The court discussed at some length that taxpayer, being controlled by Young, must be taken to have known that declaring dividends would increase Young's surtaxes—a proposition scarcely requiring argument. If knowledge of such a result is to be the test of purpose, then the only corporations that could safely accumulate income would be those having stockholders with substantial net losses. The statute does not say 'a' purpose, but 'the' purpose. The issue is not what are the necessary, and to that extent contemplated consequences of the accumulation, but what was the primary or diminant purpose which led to the decision. Cf. *Commissioner of Internal Revenue* v. *Duberstein*, 1960, 363 U.S. 278, 80 S. Ct. 1190, 4 L. Ed. 2d 1218. The Tax Court's test was altogether too favorable to the Government."

Authorities holding that the purpose to avoid income tax need not be the dominant, controlling, or impelling motive behind an accumulation seem to originate from an observation made by the Supreme Court in *Helvering* v. *Chicago Stock Yards Co.*, 318 U.S. 693 (1943). In that case, which involved the accumulated earnings tax provisions, the Court sustained a Board of Tax Appeals' finding that the Chicago Stock Yards Company had been availed of for the purpose of avoiding income tax with respect to its shareholder. The Court said in part:

"A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the

> additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax induced, *or aided in inducing*, the continuance of the practice." (318 U.S., 693, 699.) [Emphasis supplied.]

The Court's language clearly implies that the purpose to avoid income tax need not be the sole purpose behind an accumulation in order for the additional tax to be imposed. However, it would greatly strain the Court's remarks to conclude that on so employing the parenthetical phrase "or aided in inducing," it was considering the important question here posed, that is to say, whether the purpose to avoid income tax need be the dominant, controlling, or impelling purpose.

There are a number of instances where motivation is the relevant consideration in determining the tax consequences of a individual's conduct. For example, 26 U.S.C.A., Section 2035(a) provides for the inclusion of property in the gross estate of a decedent "to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, in contemplation of his death." Section 2035(a) does not by its terms require the inclusion within the gross estate of property transferred "solely" or "predominately" in contemplation of death. Nonetheless, it has been held consistently that the death motive must be the dominant, controlling, or impelling motive behind the transfer in order for it to be deemed a transfer in contemplation of death. *United States v. Wells*, 283 U.S. 102 (1931); *City Bank Farmer's Trust Co. v. McGowan*, 323 U.S. 594 (1944); *Allen v. Trust Company of Georgia, et al.*, 326 U.S. 630 (1946). Further, in determining whether the transfer of property by an individual is a gift within the meaning of 26 U.S.C.A., Section 102(a) "the proper criterion * * * is one that inquires what the basic reason for his conduct was in fact—the dominant reason that explains his action in

making the "transfer." *Commissioner v. Duberstein*, 363 U.S. 278, 286 (1960).

In our view there is no sound reason why the "dominant, controlling, or impelling" motive test employed in connection with the gift in contemplation of death provision should not be applied to the accumulated earnings tax provision. Both provisions have as their underlying purpose the prevention of tax avoidance which is made possible by the structure of the income tax laws. Neither provision explicitly sets out the extent to which the proscribed purpose must play a part in the transaction or conduct in order for the tax consequences to attach. To hold that the dominant, controlling, or impelling motive criterion is inapplicable in the case of the accumulated earnings tax provision would require that we make a distinction where no material difference exists. Accordingly, we conclude that tax avoidance must be the dominant, controlling, or impelling motive behind an accumulation in order to impose the accumulated earnings tax.

Throughout his charge the District Judge spoke in terms of the taxpayer being "availed of for the purpose of avoiding the income tax with respect to its shareholder." As witnessed by our previous discussion, this language is subject to a number of interpretations. At the conclusion of the charge, counsel for the Government called the court's attention to this fact and, in substance, asked that the jury be given the benefit of an interpretation of the language. The District Judge failed to give such an interpretation.

Considering the District Judge's charge as a whole, we are of the opinion that the jury might well have been led to believe that tax avoidance must be the sole purpose behind an accumulation in order to impose the accumulated earnings tax. While it was entirely proper for the District Judge to use the exact language of the statute in the course of his charge, it was prejudicial error not to clarify the crucial statutory language which was clearly subject to more than one interpretation, particularly when the problem had been called to his attention. Ac-

cordingly, the judgment of the District Court is reversed and the case remanded for a new trial.[3]

[3] Having reached this conclusion, it is unnecessary to consider or pass upon the arguments made by the Government in connection with the District Court's denial of a request for a continuance and also its efforts to impeach the jury's verdict.

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 16,788

THE DONRUSS COMPANY, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Before: O'SULLIVAN and CELEBREZZE, Circuit Judges and BATTISTI, District Judge.

JUDGMENT

Appeal from the United States District Court for the Western District of Tennessee.

This Cause came on to be heard on the record from the United States District Court for the Western District of Tennessee and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby reversed and the case remanded for a new trial.

No costs awarded. Rule 23(4).

Entered by order of the Court.

CARL W. REUSS, *Clerk.*

A true copy.

Attest:

CARL W. REUSS, *Clerk.*

SUPREME COURT OF THE UNITED STATES

No. 963, October Term, 1967

UNITED STATES, PETITIONER

v.

THE DONRUSS COMPANY

ORDER ALLOWING CERTIORARI—Filed April 22, 1968

The petition herein for a writ of certiorari to the United States Court of Appeals for the Sixth Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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In the Supreme Court of the United States

OCTOBER TERM, 1967

No. —

UNITED STATES OF AMERICA, PETITIONER

v.

THE DONRUSS COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The district court did not render an opinion. The opinion of the court of appeals (App. 11–22)[1] is not yet reported.

JURISDICTION

The judgment of the court of appeals (App. 22–23) was entered on September 27, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "App." refers to the printed Appendix to this petition. "R." refers to the printed record in the court of appeals.

285-693—67——1

STATUTE INVOLVED

Internal Revenue Code of 1954:

Sec. 531. Imposition of accumulated earnings tax.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

(26 U.S.C. 531.)

Sec. 532. Corporations subject to accumulated earnings tax.

(a) *General Rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * * * *

(26 U.S.C. 532(a).)

Sec. 533. Evidence of purpose to avoid income tax.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a cor-

poration are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.
(26 U.S.C. 533(a).)

QUESTION PRESENTED

Whether for the tax imposed on accumulated corporate earnings of a corporation "availed of for the purpose of avoiding the income tax with respect to its shareholders" to apply, it is necessary that the corporation have as its "dominant, controlling, or impelling" motive the avoidance of income tax on its stockholders, as the court below held, or whether it is sufficient, as the United States contends, that such a motive is one of the purposes of the accumulation.

STATEMENT

Respondent is a corporation which is engaged primarily in the manufacture and sale of bubble gum and candy, and also operates a farm (R. 9a, 38a, 210a). It was incorporated in 1947 with an initial capitalization of $60,000. Its accumulated earnings and profits amounted to $1,638,708.34 at the end of its 1960 taxable year, and $1,679,315.37 at the end of 1961. During 1960 and 1961 its net profits before taxes were $166,014.61 and $60,154.31, respectively. Current assets exceeded current liabilities by a ratio of more than 8 to 1 in 1960 and 14 to 1 in 1961. (R. 9a, 32a, 34a–36a, 209a–210a.)

Respondent never paid any dividends; its president is the only stockholder (R. 210a).

The Commissioner of Internal Revenue assessed accumulated earnings taxes against respondent for 1960 and 1961 under Section 531 of the 1954 Code. Respondent paid and brought a refund suit. In its instructions to the jury, the district court at several points stated that for the accumulated earnings tax to be imposed, avoidance of taxes on the corporation's shareholder had to be "the purpose" of the accumulations (R. 153a, 168a, 169a, 170a). The government objected on the ground that the failure to explain the significance of the word "the" could lead the jury to conclude that tax avoidance was required to be the sole purpose of the accumulation, rather than one of the purposes (R. 172a–173a, 176a, 186a). The court refused the government's express request that the jury be instructed (App. 17):

> it is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings; it is sufficient if it is one of the purposes for the company's accumulation policy.

Two special interrogatories were posed. In answer to the first, the jury found that respondent permitted its earnings for 1960 and 1961 to accumulate beyond the reasonable needs of the business. But in response to the second, the jury concluded that respondent had not retained the accumulations for "the purpose" of avoiding the income tax on its stockholder. The result was a verdict and a judgment for respondent. (R. 211a–213a.)

The Court of Appeals for the Sixth Circuit held that the charge was erroneous. But the court refused to hold that the government's requested instruction should have been given. Rather, it held that on a new trial the jury should be instructed that the accumulated earnings tax applies only if tax avoidance was the "dominant, controlling, or impelling motive" behind an excessive accumulation of earnings (App. 16-22.)

REASONS FOR GRANTING THE WRIT

1. The ruling below that earnings accumulated beyond a corporation's reasonable business needs are subject to the surtax only if the "dominant purpose" of the accumulation was to avoid taxes on shareholders conflicts with the decision of four other courts of appeals. The Second Circuit stated in *Trico Products Corp.* v. *Commissioner*, 137 F. 2d 424, 426, certiorari denied, 320 U.S. 799, that it could not "subscribe to the view that the prevention of the imposition of surtaxes must have been shown to have been the dominant factor behind the accumulations." Instead, it accepted this Court's statement in *Helvering* v. *Stock Yards Co.*, 318 U.S. 693, 699, that tax avoidance need only have "induced, or aided in inducing" the accumulations. In like manner the Fifth Circuit expressly refused to find error in the Tax Court's failing to find that tax avoidance "was the primary or dominant purpose." *Barrow Manufacturing Co.* v. *Commissioner*, 294 F. 2d 79, 82, certiorari denied, 369 U.S. 817. The Tenth and Eighth Circuits have expressly ruled that the accumulated earnings tax may be imposed where the proscribed purpose is "one of the determining

purposes" of the accumulation. *World Pub. Co.* v. *United States,* 169 F. 2d 186, 189 (C.A. 10), certiorari denied, 335 U.S. 911; *Kerr-Cochran, Inc.* v. *Commissioner,* 253 F. 2d 121, 123 (C.A. 8).[2]

2. The decision below is inconsistent with the statutory purpose. The views of the Second, Fifth, Eighth and Tenth Circuits are correct. Sections 531 and 532(a) of the 1954 Code impose a special tax on the undistributed income of a corporation which is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders * * * by permitting earnings and profits to accumulate instead of being divided or distributed." Ever since the first modern income tax law, Congress has employed this additional tax to deter the use of corporations as a tax avoidance device. See Income Tax Act of 1913, § II(A) (Subdivision 2), Ch. 16, 38 Stat. 114, 166. Although the ultimate test has always been the subjective "purpose" of the accumulation, Congress from the first recognized the difficulties of proving motive. Therefore, the first income tax act made the accumulation of "gains and profits * * * beyond the

[2] The First Circuit, on the other hand, has suggested that it might accept the Sixth Circuit's "dominant purpose" test. See *Young Motor Co.* v. *Commissioner,* 281 F. 2d 481, 491 (C.A. 1); *Apollo Industries, Inc.* v. *Commissioner,* 358 F. 2d 867, 875–876 (C.A. 1). In *Young Motor,* the corporation did not accumulate, and in *Apollo* may not have accumulated, earnings beyond its reasonable business needs. Section 535(c) of the 1954 Code expressly excludes from the tax whatever part of an accumulation is required by the corporation's reasonable needs. This section did not apply to the tax year in question in *Young Motor,* and is not referred to in the *Apollo* opinion.

reasonable business needs * * * prima facie evidence of a purpose to escape the surtax." *Ibid.*

Since 1938, accumulation of excessive earnings has been "determinative of the purpose to avoid the income tax" unless the taxpayer proved to the contrary. Revenue Act of 1938, § 102(c), Ch. 289, 52 Stat. 447; 1954 Code, Section 533(a). The next year a Congressional committee noted that the purpose of making an unreasonable accumulation nearly conclusive evidence of the prohibited purpose was to require a corporation with such earnings "to prove the absence of *any* purpose to avoid surtaxes" on its shareholders in order to itself avoid the accumulated earnings tax. (Emphasis supplied.) H. Rep. No. 885, 76th Cong., 1st Sess., p. 6 (1939). See *Barrow Manufacturing Co.* v. *Commissioner, supra*; *United Business Corp.* v. *Commissioner,* 62 F. 2d 754, 755 (C.A. 2); Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed., 1966), Sec. 6.02, pp. 218-219.

The result below substantially weakens the presumption based on a finding—such as the jury made in this case—that earnings have been accumulated beyond the reasonable needs of the business, since it permits the corporation to escape the tax merely by introducing testimonial evidence that the accumulations were prompted by one or more subjective reasons in addition to tax avoidance. See *Barrow Manufacturing Co.* v. *Commissioner, supra,* at p. 82. By opening this possibility of escape from the tax, the Sixth Circuit has, as a practical matter, substantially undermined the purpose of the accumulated earnings

tax—"to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable" for income tax on the dividends received at the graduated ordinary income rates. *Helvering* v. *Stock Yards Co., supra,* at p. 699.

3. The applicability of the accumulated earnings tax is a frequent subject of contention between the Commissioner of Internal Revenue and taxpayers, both at the administrative level[3] and in the courts.[4] The conflict among the circuits leaves the Commissioner and taxpayers uncertain of the standard to be applied. Review by the Court is therefore necessary to allow even-handed treatment of similarly-situated taxpayers.

[3] As of October 31, 1967 there were more than 200 such cases pending at the appellate conference level of the Service. In the first 10 months of 1967, another 200 cases involving the accumulated earnings tax were settled at appellate conferences in the Service. Others—the number is not known—were settled at lower administrative levels. The number of such matters pending at lower administrative levels is not presently known.

[4] At this time a total of 350 cases involving the accumulated earnings tax are pending in the district courts, the Court of Claims, and the Tax Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.
MITCHELL ROGOVIN,
Assistant Attorney General.
HARRIS WEINSTEIN,
Assistant to the Solicitor General.
MEYER ROTHWACKS,
THOMAS SILK, JR.,
KARL SCHMEIDLER,
Attorneys.

DECEMBER 1967.

285-693—67—2

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 16788

THE DONRUSS COMPANY, PLAINTIFF-APPELLEE,

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Appeal from the U.S. District Court for the Western District of Tennessee

Decided September 27, 1967

Before: O'SULLIVAN and CELEBREZZE, Circuit Judges, and BATTISTI, District Judge.*

BATTISTI, District Judge. The Commissioner of Internal Revenue assessed and collected from appellee, The Donruss Company (hereafter Donruss), accumulated earnings taxes for the taxable years 1960 and 1961. Thereafter, Donruss brought an action for the refund of said taxes in the District Court for the Western District of Tennessee. On the basis of a jury's responses to special interrogatories, the District Court entered judgment for Donruss. The United States appeals.

* Honorable Frank J. Battisti, United States District Judge for the Northern District of Ohio, sitting by designation.

The interrogatories which were submitted to the jury, and the responses thereto, are as follows:

"1. Did plaintiff corporation permit its earnings or profits for the following years to accumulate beyond the reasonable or reasonably anticipated needs of its business?

	Answer
Year ended January 31, 1960	*Yes*
Year ended January 31, 1961	*Yes*

"2. Were such accumulations retained by plaintiff corporation for the purpose of avoiding the income tax on its shareholder, Don Wiener?

	Answer
Year ended January 31, 1960	*No*
Year ended January 31, 1961	*No* "

In this appeal the Government does not specifically question the propriety of the above-quoted interrogatories. Rather, it urges that the portion of the District Court's general charge explaining the principles underlying the same was misleading and incorrect.

Section 531 of the Internal Revenue Code of 1954 imposes an accumulated earnings tax on every corporation which, as described in Section 532, is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders * * *, by permitting earnings and profits to accumulate instead of being divided and distributed." Section 533(a) provides that where earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business, this fact "shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."

The ultimate question in every accumulated earn-

ings tax case is not whether earnings and profits have been accumulated beyond the reasonable needs of the business but whether they have been accumulated for the purpose of avoiding income tax with respect to shareholders. While the reasonableness or unreasonableness of an accumulation is a most significant factor to be considered, particularly with regard to the Section 533(a) presumption, it is not necessarily determinative of the ultimate question, that is to say, whether the corporation was availed of for the proscribed purpose. In *United States* v. *R. C. Tway Coal Sales Co.*, 75 F. 2d 336 (1935) at p. 337, this court said:

> "It is the accumulation of surplus plus its interdicted purpose that brings the statute into operation, and its size in relation to business needs is but a circumstance out of which a presumption of improper purpose arises, though such purpose may be shown by pertinent evidence with or without the presumption as an aid. This view is undoubtedly that of the Court of Appeals of the Second Circuit in *United Business Corp.* v. *Commissioner*, 62 F. 2d 754, 755, and may be accepted as sound. The practical application of the interpretation may, however, in most circumstances be of little importance. The condemned purpose in the forming or utilization of corporations described in the section is the avoidance by stockholders of surtaxes. This purpose may be proved unaided by presumption, but the fact that surplus is not unreasonably large in respect to the needs of the corporation's business is repugnant to the existence of such purpose, and, while not conclusive, must be accepted as substantial evidence in denial of proofs or inferences that it exists."

Thus, if the proscribed purpose is present, the accumulated earnings tax may be imposed even though the

accumulation is reasonable. *United States* v. *R. C. Tway Coal Sales Co., supra; Whitney Chain & Mfg. Co.* v. *Commissioner,* 149 F. 2d 936 (C.A. 2 1945); *Pelton Steel Casting Co.* v. *Commissioner,* 251 F. 2d 278 (C.A. 7 1958). On the other hand, if the proscribed purpose is not present, the accumulated earnings tax may not be imposed notwithstanding an unreasonable accumulation. *Duke Laboratories, Inc.* v. *United States,* 337 F. 2d 280 (C.A. 2 1964).

In urging that the District Court's charge was erroneous and misleading, the Government has alluded to certain portions thereof wherein the court discussed the factors which the jury could take into consideration in determining whether earnings and profits were accumulated to meet the "reasonable needs of the business." However, since the jury concluded that the earnings and profits were not accumulated to meet the reasonable needs of the business, any error in this regard would not constitute prejudicial error.

The Government also urges that the charge was erroneous and misleading in that it could have led the jury to conclude that if the accumulations were reasonable there could be no purpose to avoid the tax or, conversely, that if the accumulations were unreasonable the tax should be imposed. For example, the court charged the jury as follows:

> "As stated, Ladies and Gentlemen, the issues in this case arise under the Statutes that Congress has enacted which provide in substance that a corporation must pay a tax called accumulated earnings tax, if it does not distribute to its stockholders all accumulated earnings in excess of what is reasonably needed by the business or in excess of the reasonably anticipated needs of the business." (TR 522)

* * * * *

"If, Ladies and Gentlemen of the jury, after a careful consideration of the evidence in the case and the instruction here given you by the Court, you find that the plaintiff taxpayer has shown by the proper quantum of proof, that is, by the greater weight or preponderance of the evidence, that the earnings here in question for the two years under consideration, were accumulated for the purpose of meeting the reasonable business needs or reasonably anticipated business needs of the plaintiff, The Donruss Company, herein, *rather than* for the purpose of avoiding taxes with respect to its sole shareholder, Mr. Weiner, you will find for the plaintiff, for each year, and report to the Court accordingly." [Emphasis supplied] (TR 535)

When the above-quoted portions of the District Court's charge are read out of context they seem to indicate that the ultimate question the jury was called upon to resolve was whether the accumulations were reasonable or unreasonable. While that would not correctly represent the applicable law, it should be noted that the Government did not object to the charge in that regard, although numerous exceptions were specifically and articulately entered. It is also notable that in various other portions of the charge the District Judge correctly stated the applicable law. For example, the court instructed the jury:

"If you find any of the earnings and profits of the plaintiff for a given year in question were allowed to accumulate beyond the reasonable needs of the business, for that particular year, this shall be determinative of the purpose to avoid the income tax with respect to its sole shareholder, for that year, unless, of course, as the Court has said, that the taxpayer proves the contrary by a preponderance of the evidence." (TR 511)

* * * * *

"The issues in this case and the respective contentions of the parties are evidence enough, the Court feels sure. If you find that the plaintiff corporation did accumulate earnings beyond a reasonable present or current needs of its business, or its reasonably anticipated business needs, for the fiscal years ending January 31, 1960 and 1961, and you further find that the purpose of such accumulation was to avoid payment of taxes by the sole shareholder of the plaintiff corporation, Mr. Weiner, then your verdict for each year herein should be for the defendant, The United States of America." (TR 533)

Under Rule 51 of the Federal Rules of Civil Procedure a party who fails to raise a particular objection is deemed to have waived the same. *Transamerica Freight Lines, Inc., et al.* v. *Universal Die Casting Co.*, 192 F. 2d 931 (C.A. 6 1951); *The Sucher Packing Co.* v. *Manufacturers Casualty Insurance Company*, 245 F. 2d 513 (C.A. 6 1957); *McPherson* v. *Hoffman*, 275 F. 2d 466 (C.A. 6 1960); *Solomon* v. *United States*, 276 F. 2d 669 (C.A. 6 1960); *Waxler* v. *Waxler Towing Co.*, 342 F. 2d 746 (C.A. 6 1965). Viewing the District Judge's charge as a whole we are unable to say that the portions quoted above so misled the jury that an abrogation of this principle is warranted. Certainly the fact that able counsel for the Government chose not to object to the same strongly indicates that the charge as a whole did not, as the Government now urges, mislead the jury with regard to a most fundamental question.

Throughout his charge the District Judge instructed the jury that they were required to determine whether Donruss was availed of for "the" purpose of avoiding income tax with respect to its shareholder. At no point during his charge did the District Judge ex-

plain to the jury the significance or meaning of the word "the" as used in the phrase "availed of for the purpose of avoiding income tax." At the conclusion of the charge the Government objected to the same on the ground that the court's failure to so explain the significance or meaning of the word "the" could have led the jury to conclude that avoidance of tax must be the sole purpose behind an accumulation. The Government also objected to the court's failure to give the following Special Request for Instruction:

> "The Court instructs you it is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings; it is sufficient if it is one of the purposes for the company's accumulation policy."

In the face of the Government's objections the District Judge refused to give any clarification as to the meaning of the phrase "the purpose."

In our view, Sections 531–535 cannot reasonably be construed to require that the purpose to avoid income tax be the sole purpose behind an accumulation before the additional tax may be imposed. Rather, the critical question appears to be whether these sections require that tax avoidance be the dominant, controlling, or impelling purpose behind an accumulation rather than simply "a" purpose. In this regard the authorities differ. In *Trico Products Co.* v. *Commissioner*, 137 F. 2d 424 (C.A. 2 1943) the court stated at p. 426:

> "Nor can we subscribe to the view that the prevention of the imposition of surtaxes must have been shown to have been the dominant factor behind the accumulations."

A similar conclusion was reached in *Barrow Mfg. Co.* v. *Commissioner*, 294 F. 2d 79, 82 (C.A. 5 1961):

> "The Tax Court found, in the language of

the statute, that petitioner was availed of 'for the purpose of preventing the imposition of the surtax upon its shareholders.' There was no error in failing to go further and find that that was the primary or dominant purpose of the accumulation. See *Young Motor Co.* v. *Commissioner,* 1960 1 Cir., 281 F. 2d 488, 491. Compare *Kerr-Cochran, Inc.* v. *Commissioner,* 8 Cir. 1958, 253 F. 2d 121, 123. Judge Learned Hand has called attention that this statute 'stands on the footing of the participants' state of mind,' viz., 'the *purpose* of preventing the imposition of the surtax upon its stockholders,' and that it may need the support of presumption, indeed be practically unenforceable without it. * * *' *United Business Corporation* v. *Commissioner,* 2 Cir., 1933, 62 F. 2d 754, 755. The utility of the badly needed presumption arising from the accumulation of earnings or profits beyond the reasonable needs of the business is well nigh destroyed if that presumption in turn is saddled with requirement of proof of 'the primary or dominant purpose' of the accumulation."[1]

The First Circuit reached an opposite conclusion in *Young Motor Co.* v. *Commissioner,* 281 F. 2d 488, 491 (C.A. 1 1960):

"The Tax Court may have been led into this error by a misconception of the precise issue. In its opinion it referred to preventing the imposition of the surtax upon stockholders as 'one' of taxpayer's purposes, and stated, 'If this purpose exists it may be accompanied by other legitimate business objectives and still the statute will apply.' The court discussed at some length that taxpayer, being controlled by Young, must be taken to have known that declaring dividends would increase Young's surtaxes—a proposition scarcely requiring argument. If

[1] See also, *Mertens,* Section 39.26 and cases cited therein.

knowledge of such a result is to be the test of purpose, then the only corporations that could safely accumulate income would be those having stockholders with substantial net losses. The statute does not say 'a' purpose, but 'the' purpose. The issue is not what are the necessary, and to that extent contemplated consequences of the accumulation, but what was the primary or dominant purpose which led to the decision. Cf. *Commissioner of Internal Revenue* v. *Duberstein*, 1960, 363 U.S. 278, 80 S. Ct. 1190, 4 L. Ed. 2d 1218. The Tax Court's test was altogether too favorable to the Government."

Authorities holding that the purpose to avoid income tax need not be the dominant, controlling, or impelling motive behind an accumulation seem to originate from an observation made by the Supreme Court in *Helvering* v. *Chicago Stock Yards Co.*, 318 U.S. 693 (1943). In that case, which involved the accumulated earnings tax provisions, the Court sustained a Board of Tax Appeals' finding that the Chicago Stock Yards Company had been availed of for the purpose of avoiding income tax with respect to its shareholder. The Court said in part:

> "A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax induced, *or aided in inducing,* the continuance of the practice." (318 U.S., 693, 699.) [Emphasis supplied.]

The Court's language clearly implies that the purpose to avoid income tax need not be the sole purpose behind an accumulation in order for the additional tax to be imposed. However, it would greatly strain the Court's remarks to conclude that on so employing the parenthetical phrase "or aided in inducing," it was considering the important question here posed, that is to say, whether the purpose to avoid income tax need be the dominant, controlling, or impelling purpose.

There are a number of instances where motivation is the relevant consideration in determining the tax consequences of a individual's conduct. For example, 26 U.S.C.A., Section 2035(a) provides for the inclusion of property in the gross estate of a decedent "to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, in contemplation of his death." Section 2035(a) does not by its terms require the inclusion within the gross estate of property transferred "solely" or "predominately" in contemplation of death. Nonetheless, it has been held consistently that the death motive must be the dominant, controlling, or impelling motive behind the transfer in order for it to be deemed a transfer in contemplation of death. *United States* v. *Wells*, 283 U.S. 102 (1931); *City Bank Farmer's Trust Co.* v. *McGowan*, 323 U.S. 594 (1944); *Allen* v. *Trust Company of Georgia, et al.*, 326 U.S. 630 (1946). Further, in determining whether the transfer of property by an individual is a gift within the meaning of 26 U.S.C.A., Section 102(a) "the proper criterion * * * is one that inquires what the basic reason for his conduct was in fact—the dominant reason that explains his action in making

the transfer." *Commissioner* v. *Duberstein*, 363 U.S. 278, 286 (1960).

In our view there is no sound reason why the "dominant, controlling, or impelling" motive test employed in connection with the gift in contemplation of death provision should not be applied to the accumulated earnings tax provision. Both provisions have as their underlying purpose the prevention of tax avoidance which is made possible by the structure of the income tax laws. Neither provision explicitly sets out the extent to which the proscribed purpose must play a part in the transaction or conduct in order for the tax consequences to attach. To hold that the dominant, controlling, or impelling motive criterion is inapplicable in the case of the accumulated earnings tax provision would require that we make a distinction where no material difference exists. Accordingly, we conclude that tax avoidance must be the dominant, controlling, or impelling motive behind an accumulation in order to impose the accumulated earnings tax.

Throughout his charge the District Judge spoke in terms of the taxpayer being "availed of for the purpose of avoiding the income tax with respect to its shareholder." As witnessed by our previous discussion, this language is subject to a number of interpretations. At the conclusion of the charge, counsel for the Government called the court's attention to this fact and, in substance, asked that the jury be given the benefit of an interpretation of the language. The District Judge failed to give such an interpretation.

Considering the District Judge's charge as a whole, we are of the opinion that the jury might well have been led to believe that tax avoidance must be the sole purpose behind an accumulation in order to impose

the accumulated earnings tax. While it was entirely proper for the District Judge to use the exact language of the statute in the course of his charge, it was prejudicial error not to clarify the crucial statutory language which was clearly subject to more than one interpretation, particularly when the problem had been called to his attention. Accordingly, the judgment of the District Court is reversed and the case remanded for a new trial.[2]

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 16,788

THE DONRUSS COMPANY, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Before: O'SULLIVAN and CELEBREZZE, Circuit Judges and BATTISTI, District Judge.

JUDGMENT

Appeal from the United States District Court for the Western District of Tennessee.

This Cause came on to be heard on the record from the United States District Court for the Western District of Tennessee and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the

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[2] Having reached this conclusion, it is unnecessary to consider or pass upon the arguments made by the Government in connection with the District Court's denial of a request for a continuance and also its efforts to impeach the jury's verdict.

said District Court in this cause be and the same is hereby reversed and the case remanded for a new trial.

No costs awarded. Rule 23(4).

Entered by order of the Court.

CARL W. REUSS, *Clerk.*

A true copy.

Attest:

CARL W. REUSS, *Clerk.*

U.S. GOVERNMENT PRINTING OFFICE: 1947

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1968

UNITED STATES OF AMERICA,
Petitioner,

v.

THE DONRUSS COMPANY,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

Bernard J. Long
Richard L. Braunstein
Bernard J. Long, Jr.
Dow, Lohnes and Albertson
600 Munsey Building
Washington, D.C. 20004
Attorneys for Respondent

Washington, D. C. - THIEL PRESS - 202 - 393-0625

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CITATIONS

Cases:

IN THE

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No. 963

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THE DONRUSS COMPANY,

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The District Court did not render an opinion. The opinion of the Court of Appeals is reported at 384 F.2d 292.

JURISDICTION

The judgment of the Court of Appeals was entered on September 27, 1967. (Pet. App. 22-23) The petition for a writ of certiorari was filed on December 26, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether, in order to prevent the application of the penalty imposed by Section 531 of the Internal Revenue Code of 1954 where the taxpayer has accumulated funds beyond the objectively definite and certain needs of its business, taxpayer must demonstrate that no consideration was given to the tax consequences of the accumulation of its earnings; or if consideration was so given, that any distribution would not result in taxable income to taxpayer's shareholders.

STATUTE INVOLVED

Sections 531, 532 and 533 of the Internal Revenue Code of 1954 are printed in the Petition, pp. 2-3.

STATEMENT

The facts are set forth in the opinion of the Court of Appeals, 384 F.2d 292, and, as pertinent hereto, are as follows:

The Commissioner of Internal Revenue assessed and collected from respondent, The Donruss Company (hereinafter referred to as "Donruss"), accumulated earnings taxes for the taxable years 1960 and 1961. Thereafter, Donruss brought an action for the refund of said taxes in the United States District Court for the Western District of Tennessee. On the basis of the jury's response to special interrogatories, the District Court entered judgment for Donruss. The United States appealed to the United States Court of Appeals for the Sixth Circuit which reversed on the ground that the District Court erred in failing to explain the significance of the word "the" when it instructed the jury that avoidance of taxes on the corporation's shareholder had to be "the purpose" of the accumulations. Rejecting petitioner's contention that the jury should be instructed that tax avoidance need only be "one of the purposes" for the company's accumulation policy, the Court of Appeals held that on remand the jury should be instructed that the accumulated earnings tax applies only if tax avoidance was the "dominant,

controlling or impelling motive" behind an excessive accumulation of earnings.

ARGUMENT

The decision below is correct, and there is no conflict or any other reason for further review.

1. Although the ruling below and the previous decisions of the United States Court of Appeals for the First Circuit, *Young Motor Co. v. Commissioner*, 339 F.2d 481 (1st Cir. 1964); *Commissioner v. Young Motor Co.*, 316 F.2d 267 (1st Cir. 1963); *Young Motor Co. v. Commissioner*, 281 F.2d 488 (1st Cir. 1960), might appear to conflict with the opinions expressed by the Second, Fifth, Eighth and Tenth Circuits,[1] a careful reading of the cases cited by petitioner leads inescapably to the conclusion that in fact there is no clear conflict of reasoned authority. In none of these cases will the Court find a studied analysis of the phrase "the purpose" appearing in Section 532(a) of the Internal Revenue Code of 1954. The Eighth Circuit merely cites with approval opinions of the Second Circuit in *Trico Products* and the Tenth Circuit in *World Publishing Co.* Furthermore the issue of taxpayer's burden of proof as it relates to the tax avoidance motive was not clearly before the court on the facts, and this issue was neither raised before, nor considered by, the court below. See *Kerr-Cochran, Inc.*, 14 CCH Tax Ct. Mem. 304 (1955). Similarly, the Tenth Circuit in *World Publishing Co.* states, without citation or analysis, that for the penalty tax to apply, tax avoidance need not be the sole purpose if it is a "determining factor." Apparently, no argument was made that it need be the "dominant, controlling, or impelling" motive. Again, the Tenth Circuit's enunciation of the rule is clearly *obiter*.

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[1] *Barrow Mfg. Co. v. Commissioner*, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962); *Kerr-Cochran, Inc. v. Commissioner*, 253 F.2d 121 (8th Cir. 1958); *World Publishing Co. v. United States*, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949); *Trico Products Corp. v. Commissioner*, 137 F.2d 424 (2d Cir.), *cert. denied*, 329 U.S. 799 (1943).

In *Trico Products Corp.*, the Board of Tax Appeals held that taxpayer must carry the burden of proving the complete absence of a tax avoidance motive. See *Trico Products Corp.*, 46 B.T.A. 346, 374 (1942). The Second Circuit affirmed without analysis. In fact, the only analytical attempt to justify petitioner's position herein was made by the Fifth Circuit in *Barrow Mfg. Co. v. Commissioner, supra.* Although the issue had not been ventilated before the Tax Court, see *Barrow Mfg. Co.*, 19 CCH Tax Ct. Mem. 195 (1960), the Fifth Circuit reasoned that the utility of the presumption arising from the accumulation of earnings beyond the objectively reasonable needs of the business would be destroyed if "saddled with requirement of proof of 'the primary or dominant purpose' of the accumulation." 294 F.2d at 82. This analysis completely misconstrues the statute because in addition to the presumption of correctness in favor of the Government, Section 533(a) provides that the fact that earnings and profits are permitted to accumulate beyond the objectively definite and certain needs of the business is determinative that the "dominant, controlling or impelling" motive of such accumulation was for the forbidden purpose to avoid shareholder taxes unless the taxpayer corporation proves by a preponderance of evidence that tax avoidance was not the "dominant, controlling, or impelling" motive. Thus, taxpayer must convince the trier of fact either that tax considerations were not involved at all; that there were other equal motivating factors; or that some other consideration controlled. The presumption is not compromised, only the quantum of proof is affected.

Because the only considered analysis of the subject phrase "the purpose" is to be found in the Sixth Circuit's opinion in the instant case, and in the opinions of the First Circuit in *Young Motor Co.*, there has been no thorough and considered debate among the circuits to bring the issue into sharp resolution for determination by this Court. Thus, there is no "real and embarrassing conflict of opinion and authority between the circuit courts of appeal." *Layne & Bowler Corp. v. Western Well Works,* 261 U.S. 387, 393 (1923) (Taft, C. J.).

2. The decision below constitutes the only reasonable construction of Section 532(a). The view of the Second, Fifth, Eighth and Tenth Circuits is ill considered and oblivious to practical reality. Section 532(a) does not provide for imposition of the penalty tax of Section 531 if tax avoidance is "a purpose" of the accumulation; "one of the purposes" of the accumulation; or even "a major purpose" of the accumulation, *cf.* INT. REV. CODE OF 1954 § 1551. The statute provides that the penalty tax shall apply if the corporation was "formed or availed of for "the purpose" of tax avoidance. This Congressional directive is clear and unambiguous. Its plain meaning is as stated by the First and Sixth Circuits: taxpayer must convince the trier of fact, not that no consideration was given to the tax consequences of the accumulation, but that the avoidance of tax was not the dominant, controlling, or impelling motive of its failure to declare a dividend.

It is submitted that the test urged by petitioner would be productive of chaos in this area of the tax law. Under this test, a corporation would be subject to the tax on retained earnings determined by the trier of fact not to be objectively necessary for the specific and definite needs of its business, see Treas. Regs. § 1.537 (1959), in every case where tax considerations entered into its determination to retain its earnings, notwithstanding the fact that taxpayer could demonstrate other valid, if not sufficiently definite and certain, reasons for the retention of earnings; and notwithstanding the fact that it would not have declared a dividend to its shareholders in any event. An officer or director of a closely held corporation may be presumed to know the tax consequences of a distribution to shareholders and such knowledge may in many circumstances determine the course of action which the corporation follows. However, to assume that mere knowledge of the tax consequences of a corporate distribution automatically triggers the application of Section 531 in all situations where funds have been retained in excess of the objectively definite and certain needs of the business, totally vitiates the requirement of Section 532(a)

that "the purpose" of the accumulation be tax avoidance. Nevertheless, under the test espoused by petitioner the question of motivation would, as a practical matter, turn upon knowledge. Under this test the only corporation which could overcome the presumption of Section 533(a) would be a corporation of which the controlling shareholders would not be subject to tax as a result of a corporate distribution.

Petitioner complains that the Sixth Circuit has emasculated the presumption of Section 533(a) and undermined the purpose of the Section 531 tax. It cites *Helvering v. Chicago Stock Yards Co.*, 318 U.S. 693 (1943) for the proposition that the purpose of the tax is to compel the distribution of unneeded earnings so as to prevent the avoidance of high rates of tax on the shareholders. With this there can be no quarrel. However, the Congressional purpose is not thwarted, and the statute is not deprived of its teeth, by relieving taxpayer of an impossible burden of proof and saddling him instead with what is certainly a very onerous one. Contrary to its claim, it is petitioner which is undermining Section 531 by writing the "purpose" test out of this section. Under petitioner's interpretation of Section 531 consideration is limited solely to a determination of "the reasonable needs of the business." This error is compounded by the government's aggressive attempt to limit the scope and extent of a taxpayer's business needs solely to liabilities appearing on its balance sheet and cash necessary to satisfy written commitments.

It is submitted that because the statutory language is clear and unambiguous and because to accord this clear statutory mandate its plain meaning not only does not violate the statutory scheme but, in fact, is wholly consistent therewith, the decision below is correct. *Malat v. Riddell*, 383 U.S. 569 (1966).

3. Respondent is not in a position to test the accuracy of petitioner's impressive statistical array as to the frequency with which the penalty tax of Section 531 is applied. Clearly, however, this presentation falls wide of the mark.

Petitioner does not indicate in how many of these cases the precise issue involved herein appears. The reports contain few similar cases. Since 1913, less than ten cases in the courts of appeal have discussed the question and in less than half of these has the issue been squarely presented. The issue could thus hardly be categorized as of sufficient moment to justify the consideration of this Court.

This lack of moment is all the more obvious when one considers that under the 1954 Code, the question of "the purpose" of tax avoidance only comes into play if taxpayer cannot establish definite and certain business needs, including reasonably anticipated business needs, for the accumulation. See INT. REV. CODE OF 1954 §§ 533(a), 535(c), 537. Although tax avoidance is the ultimate statutory issue, as a practical matter, the most frequently contested question is whether the corporation's earnings have accumulated "beyond the reasonable needs of the business." The fact that so few taxpayers have availed themselves of the chance to prove that the accumulation was not motivated by tax considerations clearly demonstrates the extreme difficulty of satisfying the "purpose" test. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 219-20, 233 (2d ed. 1966). Thus, only two cases involving the "purpose" test have reached the courts of appeal under the 1954 Code, the instant matter and the subsequent case of *The Shaw Walker Co. v. Commissioner,* 68-1 U.S. Tax Cas. ¶ 9211 (6th Cir. 1968) in which the Sixth Circuit reaffirmed its position.

CONCLUSION

The petition for a writ of certiorari should be denied.

Bernard J. Long
Richard L. Braunstein
Bernard J. Long, Jr.

Dow, Lohnes and Albertson
600 Munsey Building
Washington, D.C. 20004

April, 1968.

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United States Constitution, statutes and regulations—Con.

In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 17

UNITED STATES OF AMERICA, PETITIONER

v.

THE DONRUSS COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The district court did not render an opinion. The opinion of the court of appeals (R. 50-60) is reported at 384 F. 2d 292.

JURISDICTION

The judgment of the court of appeals was entered on September 27, 1967 (R. 3, 61). The petition for a writ of certiorari was filed on December 26, 1967, and was granted on April 22, 1968 (R. 62). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether application of the tax imposed on accumulated earnings of a corporation "availed of for the purpose of avoiding the income tax with respect

to its shareholders" requires, as the court below held, that the corporation have as its "dominant, controlling, or impelling" motive the avoidance of income tax on its stockholders, or whether it is sufficient, as the United States contends, that such a motive is one of the purposes of the accumulation.

STATUTE INVOLVED

Internal Revenue Code of 1954:

Sec. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

[26 U.S.C. 531]

Sec. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) *General Rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * * * *

[26 U.S.C. 532(a)]

Sec. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

[26 U.S.C. 533(a)]

STATEMENT

Respondent is a corporation engaged in the manufacture and sale of bubble gum and candy and the operation of a farm. (R. 4; see Def. Exh. 49, R. 15; Tr. 430, 467).[1] Since 1954, all of the company's outstanding stock has been owned by Don B. Wiener (R. 17).[2]

In each of the taxable years 1955 through 1961[3] respondent operated profitably. Although its undistributed earnings increased during that period from $1,021,288.58 to $1,679,315.37, the company declared no dividends (R. 11–12; Def. Exh. 49, *supra*).

The Commissioner assessed accumulated earnings taxes against respondent for the years 1960 and 1961 under Section 531 of the Internal Revenue Code of 1954 (R. 4). Respondent paid the tax and brought

[1] "Tr." references are to the transcript of proceedings in the district court, which are a part of the record in this Court.

[2] In 1954, the corporation redeemed the 50 per cent stock interest of a second individual (Tr. 57–59; Def. Exh. 49, *supra*).

[3] Respondent's taxable year runs from February 1 through January 31 (R. 4).

this refund suit (R. 5–6). The case was tried before a jury, where the following facts appeared:

Respondent's pre-tax net profits for 1960 and 1961 were $166,014.61 and $60,154.31, respectively. Its accumulated earnings amounted to $1,638,708.34 at the end of fiscal 1960 and $1,679,315.37 at the close of fiscal 1961. (Def. Exh. 49, *supra.*) Current assets exceeded current liabilities by a ratio of more than 8 to 1 in 1960 and 14 to 1 in 1961 (R. 9–10; Def. Exh. 48, R. 13; Tr. 428, 462, 467). Mr. Wiener, the sole stockholder, testified that the reason for accumulating the corporate earnings was to purchase stock of the company's major distributor, Tom Huston Peanut Company. But, he stated, as of 1961 there was no fixed and definite plan for such an acquisition (Tr. 81–84, 292–294).[4] Other reasons given for the accumulation included the possibility of a depression (Tr. 286) or war (Tr. 287), and the desire to follow, by expansion, in the "footsteps" of the Wrigley Chewing Gum Company (Tr. 149–151).

In its charge to the jury, the district court several times instructed that, for the accumulated earnings tax to apply, avoidance of tax on the corporation's shareholder had to be "the purpose" of the accumulations (R. 19, 20, 21, 22, 33, 34). The government objected on the ground that the jury would believe

[4] Respondent's treasurer testified that he first learned in 1963 of plans to acquire the Huston stock (Tr. 356–358). When the revenue agent examined respondent's books in 1961 and discussed the earnings accumulations with Mr. Wiener, no mention was made of a plan to purchase the stock (Tr. 470).

that tax avoidance must be the sole purpose of the accumulation, rather than one of the purposes (R. 40-41, 42, 43). The government specifically requested that the jury be instructed (R. 36):

> it is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings; it is sufficient if it is one of the purposes for the company's accumulation policy.

The court refused this instruction. Throughout its charge, it used the statutory language only, instructing the jury that the issue was whether "the purpose" was to avoid income tax, without further explanation.

The jury, in response to interrogatories, found that during the years in issue respondent had accumulated its earnings beyond the reasonable needs of the business. It also found that respondent had not retained its earnings for "the purpose" of avoiding the income tax on its shareholder, Mr. Wiener (R. 36). Judgment was entered for the respondent on this verdict (R. 37-39), and the United States appealed.

The court of appeals reversed and remanded for a new trial, holding that under the charge "the jury might well have been led to believe that tax avoidance must be the sole purpose behind an accumulation * * *" (R. 59). In reaching this result, however, the court rejected the government's argument that the tax applies if tax avoidance is one of the purposes of the excessive accumulation, and ruled that the jury should be instructed that the tax applies only if tax

avoidance is the "dominant, controlling or impelling motive" (R. 58–60).[6]

As this limitation on the construction of the statute was in conflict with the decisions of other courts, and inconsistent with this Court's own approach in *Helvering* v. *Stock Yards Co.*, 318 U.S. 693, 699, the government sought review from this Court.

INTRODUCTION AND SUMMARY OF ARGUMENT

Under our system of income taxation, corporate earnings "are not taxed to the shareholder when they accrue to the corporation, but instead when they are passed to shareholders individually through dividends." *Commissioner* v. *Gordon*, decided May 20, 1968, Nos. 760 and 781, 1967 Term, Slip Op. 7 n. 5. Because of the disparity between corporate tax rates and the higher graduations of individual income tax rates, a corporation—particularly a closely-held one—can significantly reduce its shareholders' tax liability by accumulating its earnings beyond the amount needed to operate the business. Absent some statutory control, a controlling shareholder, by avoiding a declaration of dividends, until "a season more propitious," *United Business Corp.* v. *Commissioner*, 62 F. 2d 754, 755 (C.A. 2), would be able to postpone the income taxes on his share of earnings in excess of the corporate needs, or convert the income to capital gain through

[6] In *Shaw-Walker Co.* v. *Commissioner*, 390 F. 2d 205, 215 (C.A. 6), pending on the Commissioner's petition for a writ of certiorari, No. 95, this Term, the court below applied the same standard to a decision of the Tax Court.

sale of his stock, or even escape income taxation by retaining his interest until death.[6] See, generally, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders,* 209 (2d ed. 1966).

To avoid these consequences, Congress, in every income tax law since the adoption of the Sixteenth Amendment, has taxed unnecessary accumulations of corporate earnings calculated to insulate shareholders from the income tax on dividends. The purpose is "to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual shareholders will become liable" for the income tax on dividends. *Helvering* v. *Stock Yards Co.,* 318 U.S. 693, 699.

The present statutory provisions, Sections 531 through 537,[7] comprise Part I of Subchapter G of the Code—a group of sanctions aimed generally at "Corporations Used to Avoid Income Tax on Shareholders." These sections have three essential features. *First,* the statute imposes (Section 531) a tax in "addition to other taxes imposed by this chapter * * * on the accumulated taxable income * * * of every cor-

[6] A shareholder could also "borrow" the accumulated earnings from the corporation without being subject to the dividend tax. See, *e.g.*, *United Business Corp.* v. *Commissioner*, *supra;* cf. Treas. Reg. Section 1.537-2(c) (1), (2), (3).

[7] Section references hereafter are to the 1954 Code, unless otherwise indicated.

The relevant provisions of the current regulations are sections 1.531-1 through 1.537-3 of the Income Tax Regulations. As far as the present question is concerned, they appear to repeat the language of the statute, and throw no further light on its proper construction.

poration"[a] that is (Section 532(a)) "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation by permitting earnings and profits to accumulate instead of being divided and distributed."

Second, there is (Section 533(a)) a rebuttable presumption that a corporation which has accumulated earnings "beyond the reasonable needs of the business" did so with "the purpose to avoid the income tax with respect to shareholders * * *." *Third*, there is a "credit" (Section 535(c)(1)) which excuses from the

[a] The Income Tax Law of 1913, part of the Tariff Act of 1913, Section IIA, Subdivision 2, Ch. 16, 38 Stat. 144, 166, taxed the *shareholders* on their pro rata shares of accumulated earnings of a corporation "fraudulently" availed of to prevent taxation of its shareholders. See Bittker and Eustice, *supra*, at 209–210. The word "fraudulently" was deleted in the Revenue Act of 1918, Section 220, Ch. 18, 40 Stat. 1072. See Revenue Act of 1916, § 3, 39 Stat. 758. It had made the provision "of little value, because it was necessary to its application that intended fraud on the revenue be established in each case." S. Rep. No. 617, 65th Cong., 3d Sess. 5(1918).

The tax on the shareholders continued through 1920. Then, "doubts apparently arose as to the validity of taxing income which the taxpayers had never received, and in 1921 it was thought safer to tax the company itself * * *." *United Business Corp. v. Commissioner*, *supra*, 62 F. 2d at 756. Although the statutory language has been changed from time to time, every income tax act since 1921 has laid the tax on the corporation, rather than the shareholders, through provisions having the same substance as the present Sections 531 and 532(a). Revenue Act of 1921, § 220, 42 Stat. 247; Revenue Act of 1924, § 220, 43 Stat. 277; Revenue Act of 1926, § 220, 44 Stat. 34; Revenue Act of 1928, § 104, 45 Stat. 814; Revenue Act of 1932, § 104, 47 Stat. 195; Revenue Act of 1934, § 102, 48 Stat. 702; Revenue Act of 1936, § 102, 49 Stat. 1676; Revenue Act of 1938, § 102, 52 Stat. 483; Internal Revenue Code of 1939, § 102(a), 53 Stat. 35.

tax so much of the accumulation as is shown to have been "retained for the reasonable needs of the business".

The issue here is whether the government's requested jury instruction correctly reflected the description in Section 532(a) of the corporations which are to be taxed: those "availed of for the purpose of avoiding the income tax with respect to its shareholders". Concretely, did Congress propose, as the government urges, that a corporation shall be subject to the accumulated earnings tax whenever tax avoidance is, in the words of the proposed instruction, "one of the purposes of" a decision to accumulate rather than distribute profits unnecessary to the business? Or, as the court below ruled, is the tax limited to those situations where the finder of fact concludes that tax avoidance was the "dominant, controlling, or impelling motive" of the accumulation?

The court below, following a 1961 decision of the First Circuit, adopted the narrower construction, relying upon the use of the definite article "the" before the word "purpose" in Section 532(a) and upon cases dealing with problems of intent under unrelated income and estate tax provisions.

We contend that the results reached in the First and Sixth Circuits are not supported by the statutory language or purpose. The corporation is "availed of" for the described statutory purpose when that purpose is one of several objectives, irrespective of whether it is the dominant or controlling purpose. In short, when tax avoidance is one of the uses for which corporate earnings are unreasonably accumulated, the accumu-

lated earnings tax should apply. The simultaneous presence of other motives at most serves to reduce the tax through application of the credit provisions of Section 535(c).

The proper result here should have been clear ever since this Court's decision twenty-five years ago in *Helvering* v. *Stock Yards Co.*, 318 U.S. 693. This Court there held that a practice of accumulating earnings begun for proper purposes became subject to the tax when "continued with the additional motive of avoiding surtax" or "the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice." 318 U.S. at 699. The Second, Fifth, Eighth and Tenth Circuits have accepted the substance of the government's position, relying on the *Stock Yards* decision as well as the language and purpose of the statute.

This line of authority, moreover, represents the only result consistent with the 1938 congressional statement of purpose—that the tax applies unless there is an "absence of any purpose to avoid surtaxes upon shareholders". S. Rep. No. 1567, 75th Cong., 3d Sess. 5 (1938). The 1954 Congress, obviously aware of these authorities, recognized that a corporation's inability to justify "a minor portion of their accumulations" could "subject their entire accumulated earnings to tax". S. Rep. No. 1622, 83d Cong., 2d Sess. 72. Congress, however, did not eliminate or substantially alter the scope of the tax; it established a credit to the extent that an accumulation satisfied demonstrable business needs (Section 535(c)(1)).

The view adopted by the First and Sixth Circuits would add a novel and unintended element to the accumulated earnings tax: even the corporation with an admitted tax avoidance purpose for an accumulation could avoid the tax entirely if the trier of fact could be persuaded that the corporate managers had given at least equal weight to other considerations when deciding to accumulate rather than distribute earnings. This result, we submit, is contrary to the statutory language, the express legislative purpose, and this Court's *Stock Yards* decision. It should be rejected here, and our proposed instruction approved.

ARGUMENT

THE ACCUMULATED EARNINGS TAX APPLIES TO EVERY UNREASONABLE ACCUMULATION OF CORPORATE EARNINGS THAT HAS TAX AVOIDANCE AS ONE OF ITS PURPOSES; SUCH PURPOSE NEED NOT BE "DOMINANT, CONTROLLING, OR IMPELLING."

A. THE LANGUAGE AND LEGISLATIVE HISTORY OF THE STATUTE DEMONSTRATE THAT CONGRESS INTENDED TO TAX ALL UNREASONABLE ACCUMULATIONS HAVING A TAX-AVOIDANCE PURPOSE

1. Sections 531 and 532(a) impose the accumulated earnings tax upon "every corporation" which has been "availed of for the purpose of avoiding the income tax with respect to its shareholders * * *." The phrase to be construed is "availed of for the purpose". The words "availed of" mean "used". The inquiry thus is the reach of a statute that depends for its application on "the purpose" for which a corporation is "availed of" or "used".

Rarely has a corporation but a single purpose for particular conduct. Any given corporation will be "availed of" for a variety of "purposes". Tax avoidance seldom will appear as the sole or even the most readily discernible motive, whether the focus of attention be an accumulation of earnings or any other corporate act. Accumulated-earnings cases invariably involve a surplus, usually held in cash or other quick or investment assets, which has a broad variety of potential uses and has been accumulated by a series of acts. Almost certainly, the purpose of tax avoidance, when present, will arguably be intermixed with other objectives. Attempts to apply the accumulated earnings tax are particularly likely to invoke assertions of multiple corporate purposes. The potential variations—of degree as well as kind—are endless.

The statutory language, however, carries no suggestion that Congress intended application of the tax to depend on the relative importance of tax avoidance within the generality of corporate purposes. The statute does not require that the corporation be "predominantly availed of" for tax avoidance, or that it have a "controlling" or "impelling" tax avoidance "purpose" for accumulating its earnings. The phrase "availed of" does not imply that the described purpose—tax avoidance—must have singular importance in the scheme of corporate operation. Nor can such a restriction be found anywhere in the relevant provisions. This is in significant contrast to other parts of the Internal Revenue Code, also addressed to possible abuses of the corporate form, which require for their application that tax avoidance be the "principal

purpose" (Sections 269(a), 357(b)(1)) or that the corporation be "used principally" for that aim (Section 355 (a)(1)(B)).

The choice of the phrase "availed of," without any such qualification, fortifies the obvious conclusion that imposition of the tax does not depend on whether tax avoidance has primacy over other corporate purposes. Once a corporation is, in the language of the subchapter title, "used to avoid income tax on shareholders," it has engaged in the conduct described in Part I of the Subchapter—"improperly accumulating surplus." Inquiry into other motives underlying the accumulation may then be proper to determine whether part of the accumulation is excused from tax under the credit provisions of Section 535(c). But that inquiry performs no broader service; nothing in the statutory words allows a full escape from the tax on the ground that the tax avoidance purpose was not dominant in the decision to accumulate rather than distribute earnings.

2. The court below, in reading the statute more narrowly, adopted the rationale of the First Circuit in *Young Motor Co.* v. *Commissioner*, 281 F. 2d 488, 491:[9]

> The statute does not say "a" purpose, but "the" purpose. The issue is not what are the necessary, and to that extent contemplated consequences of the accumulation, but what was the primary or dominant purpose which led to the decision [to accumulate]. Cf. *Commissioner of*

[9] See, also, *Appollo Indus., Inc.* v. *Commissioner*, 358 F. 2d 867 (C.A. 1)

Internal Revenue v. *Duberstein*, 1960, 363 U.S. 278 * * *.

The conclusion is premised on one word of the statute—the definite article "the" appearing before the word "purpose". But this analysis not only gives an unduly narrow effect to the simple word "the," but it overlooks other essential language. The definife article appears not in isolation, but in the phrase "availed of for the purpose * * *." The total phrase is by itself indefinite, and, as a matter of ordinary English usage, not restricted by the "the" within it. Any reading of the phrase as requiring that tax avoidance be the "dominant, controlling, or impelling motive" should rest on language qualifying the words "availed of". There is, of course, no such modifier in Section 532(a), or anywhere else in the accumulated earnings provisions of the Code.

No other result may fairly be inferred from *Duberstein* or the three estate tax cases upon which the court below relied, *United States* v. *Wells*, 283 U.S. 102; *City Bank Farmers Trust Co.* v. *McGowan*, 323 U.S. 594; and *Allen* v. *Trust Co. of Ga.*, 326 U.S. 630. The question in *Duberstein* was whether a certain transfer was a "gift," which Section 22(b)(3) of the 1939 Code (now Section 102(b)) excludes from gross income—a problem which has no connection with the phraseology or purposes of Section 532(a).

Section 2035(a)—the provision involved in the cited estate tax cases—speaks of transfers "made * * * in contemplation of * * * death"—language that suggests a need to find a principal controlling thought on the part of the transferor: "the motive * * * must

be of the sort which leads to testamentary disposition". *United States* v. *Wells, supra,* 283 U.S. at 117.

Moreover, the above cases represent two instances in the wide range of human affairs with which the tax code must deal. Each situation presents its own definitional problems, each encrusted with its own historical development. Thus, in *Duberstein,* this Court was unwilling to draw on precedents based on other provisions of the tax code. "Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious. See *Lockard* v. *Commissioner,* 166 F. 2d 409." *Commissioner* v. *Duberstein, supra,* 363 U.S. at 284. This is particularly true here, where the Sixth Circuit has attempted to engraft on Section 532(a)—a provision dealing with an income tax problem applicable only to corporations—an agglomeration of two lines of precedent, neither relevant to the other and each from a context entirely alien to the accumulated earnings tax.[10]

[10] Any analogy to other provisions of the Code must be based on the fact that the accumulated earnings impost is not the usual income tax, but is a regulatory, "penalty" provision, S. Rep. No. 1622, 83d Cong., 2d Sess. 68 (1954). *Helvering* v. *National Grocery Co.,* 304 U.S. 282, 288-289, 290; see, also *Helvering* v. *Mitchell,* 303 U.S. 391, 405 n. 15. Thus if there is any relevance in cases dealing with provisions outside Subchapter G, it lies in cases such as *Spies* v. *United States,* 317 U.S. 492, 499, where, in the same term as the *Stock Yards* decision, *supra,* this Court decided that *criminal* fraud penalties apply "[i]f the tax-evasion motive plays any part in such conduct, [the likely effect of which would be to mislead or to conceal] * * * even though the conduct may also serve other purpose such as concealment of other crime." No more can be required here, in dealing with a civil provision that Congress—in 1918—decided should be applied more readily than one based on fraud. See note 8, *supra.*

3. Congress itself has made clear that its use of the definite article does not have the significance attached to it by the court below. Until 1938, the predecessor of the presumption in Section 533(a) made an unreasonable accumulation "*prima facie* evidence of *a* purpose to avoid surtax'' upon shareholders, although the taxing provision then, as now, was addressed to corporations "availed of for *the* purpose * * *". *E.g.*, Revenue Act of 1932, § 104(a), (b), 47 Stat. 169, 195. (Emphasis supplied.) The definite article before the word "purpose" could hardly have been intended to control application of the statute when the companion presumption used the indefinite "a" at the parallel point.

When Congress, in the Revenue Act of 1938, Section 102(c), Ch. 289, 52 Stat. 447, 483, adopted the current wording of the presumption—that an unreasonable accumulation of earnings shall be "*determinative* of the purpose to avoid [income] tax" (emphasis supplied)—it made very clear that it was increasing the taxpayer's burden of proof, and not, as the Sixth Circuit would reason from the insertion of a definite article, creating an additional barrier to imposition of the tax. The legislative purpose was to replace the mere "prima facie" presumption with a "determinative" one to combat tax avoidance that had persisted "to a considerable extent" under pre-1938 law. S. Rep. No. 1567, 75th Cong., 3d Sess. 4 (1938). By making the presumption "determinative," Congress shifted to the taxpayer not only the burden of going forward, as under prior law, but also the burden of proof, see *id.* at 16. The Senate Finance Committee described

the change as "requiring the taxpayer by a clear preponderance of the evidence to prove the absence of *any* purpose to avoid surtaxes upon shareholders after it has been determined that the earnings and profits have been unreasonably accumulated." *Id.* at 5 (emphasis supplied); see, also, H. Rep. No. 855, 76th Cong., 1st Sess. 6 (1939).

Congress, when it adopted the 1954 Code, recognized that the accumulated earnings provisions had been interpreted in the manner indicated in the 1938 legislative history—commenting that corporations "feared" that an inability to justify "a minor portion of their accumulations * * * will subject their entire accumulated earnings to tax." S. Rep. No. 1622, 83d Cong., 2d Sess. 72 (1954). Congress, however, rejected [11] requests for repeal of the tax.[12] Instead, it dealt with the seeming inequity of taxing in its entirety an ac-

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[11] Congress thought it "necessary to retain the penalty tax on unreasonable accumulations as a safeguard against tax avoidance". H. Rep. No. 1337, 83d Cong., 2d Sess. 52(1954); S. Rep. No. 1622, *supra* at 68.

[12] The present presumption requires the taxpayer with an unreasonable accumulation to prove an absence of the tax avoidance purpose by "the preponderance of the evidence" (Section 533(a)). Prior law spoke of a "clear preponderance". *E.g.*, Section 102(c) of the Internal Revenue Code of 1939. No change in standard seems to have been intended. Thus Congress commented that a taxpayer "must bear the burden of proof as under existing law" unless it took advantage of a procedure that the 1954 Code created for shifting the burden to the government in Tax Court cases by serving upon the Commissioner (Section 534(c)) "a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business". H. Rep. No. 1337, *supra* at 52; S. Rep. No. 1622, *supra* at 71.

cumulation partially motivated by proper purposes by adopting the "accumulated earnings credit" of Section 535(c)(1), which provides that the tax shall not apply to "such part of the earnings and profits * * * as are retained for the reasonable needs of the business * * *."[13]

Thus, the Congressional plan is to make the tax inapplicable, even if there is a tax avoidance motive, to that part of the accumulation that is reasonable, but only to that extent. If the corporation has a variety of motives for the accumulation, it does not matter which predominates. Congress has instead provided for elimination of the tax to the extent that demonstrable business needs justify the accumulation. But any portion that cannot be justified—even the "minor portion" referred to in S. Rep. 1622, *supra* at 72—is to be taxed under Section 531.

B. THE STATUTORY PURPOSE OF COMPELLING DISTRIBUTION OF PROFITS NOT NEEDED FOR THE CONDUCT OF THE BUSINESS REQUIRES APPLICATION OF THE ACCUMULATED EARNINGS TAX UNLESS THERE IS A COMPLETE ABSENCE OF TAX AVOIDANCE MOTIVE FOR AN UNREASONABLE ACCUMULATION

The target of the accumulated earnings tax is described in the final words of Section 532(a)—tax

[13] Section 535(c)(2) sets the minimum exclusion at "the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year." By this provision a corporation is allowed to accumulate over its life $100,000 free of the accumulated earnings tax. In practical effect, small businesses are excepted from the tax in most instances. See H. Rep. No. 1337, *supra* at 53-54; S. Rep. No. 1622, *supra* at 71-72.

avoidance "by permitting earnings and profits to accumulate instead of being divided or distributed". The tax is specifically designed to deter conduct—"the manipulation of dividends to avoid taxes," *United Business Corp.* v. *Commissioner, supra,* 62 F. 2d at 756; the method is "to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual shareholders will become liable" for income taxes on their dividends. *Helvering* v. *Stock Yards Co., supra,* 318 U.S. at 699.

The ultimate fact that brings the accumulated earnings tax into play is the subjective tax-avoidance motive of those in command of corporate affairs. But such questions of intent are not satisfactorily tried on the basis of the self-serving, after-the-fact, trial testimony of the corporate managers. They are better determined on the basis of the contemporaneous words and deeds that more accurately reflect the true motives. The evidence of these objectively ascertainable facts, however, is largely in the control of those who at trial assert the propriety of their earlier purposes. In consequence, as Judge Learned Hand explained in holding the 1921 accumulated earnings tax valid, "A statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it * * *." *United Business Corp.* v. *Commissioner, supra,* 62 F. 2d at 755; see, also, *Barrow Manufacturing Co.* v. *Commissioner,* 294 F. 2d 79, 82 (C.A. 5), certiorari denied, 369 U.S. 817. This is the reason for the presumption in Section 533(a), which makes

an unreasonable accumulation determinative on the issue of tax-avoidance purpose in the absence of a contrary showing. The idea is to "make the taxpayer show his hand"—"to compel the taxpayer to disclose the facts". *United Business Corp.* v. *Commissioner, supra,* 62 F. 2d at 755, 756.

Through the presumption, Congress intended that a corporation's claims of proper motive be tested primarily against what was contemporanously said and done. Thus, the Senate Finance Committee said, in discussing a 1954 amendment that allowed accumulations of amounts intended for future use—*i.e.* "the reasonably anticipated needs of the business" (Section 537), (S. Rep. 1622, *supra* at 69):

> It is contemplated that this amendment will cover the case where the taxpayer has specific and definite plans for acquisition of buildings or equipment for use in the business. It would not apply where the future plans are vague and indefinite, or where execution of the plans is postponed indefinitely.

The practical workings of the presumption mirror this statutory purpose. Once it is shown, as Section 533(a) requires, that earnings have accumulated "beyond the reasonable needs of the business," the taxpayer must, "by a preponderance of the evidence" negative "the purpose to avoid the income tax with respect to shareholders". Of necessity, there is at this stage no credible objective evidence to reinforce claims of proper motives; otherwise the presumption would not have come into play. If, nevertheless, the taxpayer's witnesses are convincing in their testimony of subjective motives other than tax avoidance,

the trier of facts can find for the corporation, and no accumulated earnings tax will be imposed. The trier of the facts may, however, reject such testimony as impeached by the objective evidence of the witnesses' earlier words and deeds.[14] If that happens, by definition there was no reason for the failure to distribute, and the tax must be applied to implement the Congressional purpose of compelling dividends when there are "profits not needed for the conduct of the business" (318 U.S. at 699).

The government's proposed rule is necessary if the courts are to effectuate this design. A finding that tax avoidance is "one" of the purposes of an accumulation "beyond the reasonable needs of the business" is equivalent to a failure to show "the absence of any" such purpose. This is precisely the circumstance when Congress intended the tax to apply, see pp. 16–17, *supra*. Thus, if the corporation fails to demonstrate need for the accumulation, the tax is applied, except in those unusual cases where the trier of facts is persuaded that tax avoidance played no part in inducing the unnecessary accumulation. Cf. *Heyward & Co.* v. *United States*, 1966-2 Tax Cases ¶ 9667 (W.D.N.C., decided Sept. 1, 1966).

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[14] For example, see *Dickman Lumber Co.* v. *United States*, 355 F. 2d 670 (C.A. 9) (claimed need for reserves to meet competition, fluctuation of business; planned modernization of plant); *Dixie, Inc.* v. *Commissioner*, 277 F. 2d 526, 528 (C.A. 2), certiorari denied, 364 U.S. 827 (no specific plan for remodeling rental premises); *Fenco, Inc.* v. *United States*, 234 F. Supp. 317, 325 (D. Md.), affirmed *per curiam*, 348 F. 2d 456 (C.A. 4) (vague plans for building). See, also, Treas. Reg. Section 1.537-1(b)(1); S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 69-70 (1954).

The First and Sixth Circuits would call for a quite different approach. The inquiry could not end upon a finding that accumulations exceeded the needs of the business and that a tax avoidance motive was present. A further inquiry would be needed to determine the relative importance of that motive among the various reasons ascribed for the accumulation. Motive is itself hard enough to determine. Assessment of the relative importance and priority of several motives is even more difficult. Generally no evidence would be available other than the trial testimony of corporate managers that in their minds any thought of tax avoidance was no more important than (or was subordinated to) other objectives. There will rarely be objective evidence by which such claims may be tested.[15] Yet, the trier of the facts would be called upon to determine what motive was "dominant, controlling or impelling".

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[15] By way of contrast, in the "gift in contemplation of death" cases on which the Sixth Circuit relied, see pp. 14–15 *supra*, the alleged primacy of the tax avoidance motive may be weighed against such other motives as normally motivate inter vivos gifts by considering such observable facts as: the decedent's relationship to the donee, the donor's statements at the time of the transfer, the donee's needs, the donor's age and knowledge of his health, and the date of drafting and the design of the donor's will. See *United States* v. *Wells*, *supra*, 283 U.S. at 118–119. Moreover, the donor will not be available and therefore the estate cannot rest on self-serving uncorroborated testimony. Even so, it has been said: "If the subjective test [of Section 2035(a)] is not an active inducement to fraud and perjury, it at least encourages what Randolph Paul euphemistically refers to as 'carefully assembled evidence' that gifts were not in contemplation of death." Lowndes and Kramer, *Federal Estate and Gift Taxes* 71 (1956), citing 1 Paul, *Federal Estate & Gift Taxation* 279 (1949).

Here, for example, respondent disclaimed any tax-avoidance purposes and contended that the earnings were accumulated with a view to acquiring a distributor and expanding to the point of competing with the Wrigley Company (although no definite plans for such corporate action had evolved), and because of fears of war or depression (Tr. 81–84, 149–151, 286–287, 292–294, 356–358, 470). The jury found that respondent's accumulation had been "beyond the reasonable or reasonably anticipated needs of its business" (R. 37)—*i.e.* that the objectively ascertainable facts did not justify the accumulation (see R. 28–29). But at the same time the jury found that "avoiding the income tax on its stockholder, Don Wiener" was not "the purpose" (R. 37)—*i.e.* tax avoidance was not the "sole" purpose (see R. 59)—of the accumulation.

It follows that respondent had available earnings that were not necessary to the conduct of the business and could have been distributed. If a corporation such as respondent can escape the penalty tax of Section 531 simply because its managers considered other factors as important as diminishing the tax burden of a sole shareholder such as Mr. Wiener, there is no significant compulsion to distribute unneeded earnings. The taxpayer may rest on unchallengeable and entirely unprovable assertions of state of mind, and no longer need "disclose the facts" (62 F. 2d at 756) that corroborate his assertions. "The utility of the badly needed presumption arising from the accumulation of earnings beyond the reasonable needs of the business is well nigh destroyed if that presumption in turn is saddled with the requirement of proof of 'the primary

or dominant purpose' of the accumulation." *Barrow Manufacturing Co. v. Commissioner, supra,* 294 F. 2d at 82.

C. A LONG LINE OF JUDICIAL DECISIONS SUPPORTS THE GOVERNMENT'S POSITION

It is of no small moment that for some forty-seven years following the first accumulated earnings tax provision there was no judicial holding that imposition of the accumulated earnings tax depended on a showing that there was a *dominant* motive to avoid taxes. Every indication save one was to the contrary, and that sole exception was a decision which this Court reversed.

Thus in 1938, the Board of Tax Appeals interpreted the 1932 predecessor of the presumption now in Section 533(a) as requiring a holding company[16] to establish "its purpose to be wholly other than that of preventing surtax upon its shareholders—not only that there was another purpose, but that there was a complete absence of the disapproved purpose. Obviously a holding or investment corporation may be formed or availed of for several purposes, but it cannot escape this tax unless it proves that it had no purpose to enable the escape of surtax." *R. L. Blaffer & Co.,* 37 B.T.A. 851, 856, affirmed, 103 F. 2d 487 (C.A. 5), certiorari denied, 308 U.S. 576.

Thereafter, the First Circuit, in reversing another decision of the Board of Tax Appeals, commented that

[16] In 1932, and now (Section 533(b)), the statute presumption provides that the fact that a "corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid * * * tax * * *."

Blaffer was "[p]erhaps * * * too strong a statement; but at least it is clear that § 104 would apply if in the totality of reasons which induced the continuing of the accumulation the forbidden motive of surtax avoidance played a substantial part." *Chicago Stock Yards Co.* v. *Commissioner*, 129 F. 2d 937, 948, reversing 41 B.T.A. 590.

This Court in turn reversed the court of appeals, holding that the Board of Tax Appeals had properly taxed an unreasonable accumulation. *Helvering* v. *Stock Yards Co., supra.* In considering the point at which a corporation "formed" before the Sixteenth Amendment became "availed of" for avoiding the tax on shareholders, the Court reasoned (318 U.S. at 699):

> A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the *additional* motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax *induced, or aided in inducing, the continuance of the practice.* [Emphasis added.]

This rationale says far more than the Sixth Circuit's view (R. 58) that this Court implied no more than "that the purpose to avoid income tax need not be the sole purpose behind an accumulation in order for the additional tax to be imposed". This Court said nothing to indicate that the corporate purposes had to become so changed that tax avoidance overcame all others in importance. It was necessary only that

there be an "additional motive of avoiding" tax. No need was discerned to inquire whether tax avoidance was the "dominant, controlling, or impelling" cause of the accumulation. It sufficed that tax avoidance "aided in inducing" the accumulation, as would be the case if, in the terms of our proposed rule, tax avoidance is "one of the purposes" of an unreasonable accumulation.

For the next seventeen years—until the First Circuit's decision in *Young Motor Co.* v. *Commissioner*, *supra*—the courts continued to agree with the government's position. In explicit reliance on *Stock Yards*, the Second Circuit refused to "subscribe to the view that the prevention of the imposition of surtaxes must have been shown to have been the dominant factor behind the accumulations." *Trico Products Corp.* v. *Commissioner*, 137 F. 2d 424, 426, certiorari denied, 320 U.S. 799; see, also, *United States* v. *Duke Laboratories, Inc.*, 337 F. 2d 280, 283 (C.A. 2) ("The problem for the jury was to determine from all the evidence whether there was any intent in making the accumulations to avoid taxes"). In like manner the Fifth Circuit expressly refused to find error in the Tax Court's failure to find that tax avoidance "was the primary or dominant purpose". *Barrow Manufacturing Co.* v. *Commissioner*, *supra*. The Tenth Circuit, followed by the Eighth, read the statute as requiring only that the proscribed purpose be one of the determining purposes of the accumulation. *World Pub. Co.* v. *United States*, 169 F. 2d 186, 189 (C.A. 10), certiorari denied, 335 U.S. 911; *Kerr-Cochran, Inc.* v. *Commissioner*, 253 F. 2d 121, 123 (C.A. 8).

The government's proposed instruction was fully in keeping with these authorities. Since, as emphasized above, the line of decisions upon which we rely is consistent with the statute and its purposes and has met with the continuing approval of Congress, we submit that there can be no sound reason for a departure.[17]

CONCLUSION

The judgment of the court of appeals should be appropriately modified and the cause remanded to the district court for a new trial, with directions to grant the government's requested instruction.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.
MITCHELL ROGOVIN,
Assistant Attorney General.
HARRIS WEINSTEIN,
Assistant to the Solicitor General.
RICHARD C. PUGH,
MARTIN T. GOLDBLUM,
Attorneys.

JULY 1968.

[17] Compare *Joint Indus. Bd.* v. *United States*, No. 616, Oct. Term, 1967, decided May 20, 1968; *Missouri* v. *Ross*, 299 U.S. 72, 75; *Canada Packers* v. *A.T. & S. F.R. Co.*, 385 U.S. 182, 184; *Reed* v. *The Yaka*, 373 U.S. 410, 414; *Francis* v. *Southern Pacific Co.*, 333 U.S. 445, 449–450.

U.S. GOVERNMENT PRINTING OFFICE: 1968

No. 17

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1968

UNITED STATES OF AMERICA, *Petitioner*

v.

THE DONRUSS COMPANY, *Respondent*

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENT

RICHARD L. BRAUNSTEIN
Attorney for Respondent
1225 Connecticut Avenue
Washington, D.C. 20036

BERNARD J. LONG
BERNARD J. LONG, JR.
RICHARD F. SWIFT
DOW, LOHNES AND ALBERTSON
Of Counsel

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OPINIONS BELOW

The district court did not render an opinion. The opinion of the court of appeals (Record at 50-60) is reported at 384 F.2d 292.

JURISDICTION

The judgment of the court of appeals was entered on September 27, 1967 (Record at 3, 61). The petition for a writ of certiorari was filed on December 26, 1967, and was

granted on April 22, 1968 (Record at 62). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a corporation which accumulates earnings beyond the definite and certain needs of its business will be subject to a penalty tax on those earnings imposed under Section 531 of the Internal Revenue Code of 1954, unless it is able to demonstrate by the preponderance of the evidence that no consideration was given to the tax result a distribution of those earnings would produce to the shareholders if passed to them as dividends.

STATUTE INVOLVED

Internal Revenue Code of 1954:

Sec. 531. Imposition of Accumulated Earnings Tax.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

[26 U.S.C. 531]

Sec. 532. Corporations Subject to Accumulated Earnings Tax

(a) *General Rule.* —The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

[26 U.S.C. 532(a)]

Sec. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.
[26 U.S.C. 533(a)]

Sec. 535. ACCUMULATED TAXABLE INCOME

(a) *Definition.*—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(c) *Accumulated Earnings Credit.*—

(1) *General Rule.*—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b)(6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) *Minimum Credit.*—The Credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

[26 U.S.C. 535(a), (c)(1), (2)]

STATEMENT

Respondent is a corporation which, during the taxable years 1960 and 1961, was engaged in the manufacture and sale of confectionery products and in addition operated a farm. Since 1954 all of respondent's outstanding stock has been owned by Donald B. Wiener. Record at 17. The farming operation conducted by respondent was initiated during the 1930's in connection with the manufacture and sale of pickles. At that time neither Mr. Wiener nor his then partner could afford to purchase a farm, so rented farm properties were utilized. Transcript at 53-4. In 1947 respondent entered into the confection business, manufacturing bubble gum and candy. *Id.*

Since its formation, respondent has been generally successful, and as petitioner notes, during the period 1955 through 1961 its earned surplus increased from $1,021,288.58 to $1,679,315.37. On the other hand, during the period 1949 through 1964 respondent's earned surplus increased by less than 50 percent. Record at 15; defendant's Exhibit 49. Respondent had net quick assets during the years 1960 and 1961 of $848,659.54 and $926,612.24, a ratio of current assets to current liabilities of 8.3 to 1 and 14.9 to 1, respectively. In 1962 this ratio increased to 27.9 to 1. However, in 1963 and 1964 the ratio declined to 7.4 to 1 and 4.8 to 1. Record at 13; defendant's Exhibit 48. While these figures indicate substantial liquid assets, respondent's ratio of net quick assets to monthly sales, the true indicator in the industry, Transcript 144-45, was considerably less than that of other gum manufacturers. While respondent enjoyed substantial annual profits from 1949 through 1964, its net quick assets, that is, assets which have not been invested in fixed assets of the business, have not substantially increased during that period. Record at 13; defendant's Exhibit 48.

During the years at issue, respondent made no loans to Mr. Wiener or his relatives, nor did it afford them luxuries, or make investments unrelated to its business.

Transcript at 483-84. Mr. Wiener testified that the company's policy of not paying dividends and of reinvesting its earnings in the business, was motivated, *inter alia*, by the recurring need for new plant and equipment; increasing wages; the inherent risk and competition in the bubble gum business; and the consequent need for diversification and expansion; and finally, the necessity of purchasing large amounts of inventory, especially sugar, as a hedge against shortages. Transcript at 48-65.

Influential also was respondent's desire to make a substantial investment in the Tom Huston Peanut Company. Although during the years at issue taxpayer admittedly had no fixed or definite plans to buy a particular number of shares at a particular price, it is clear that since 1949 Mr. Wiener had expressed on numerous occasions a desire to make a substantial investment in the Tom Huston Peanut Company.[1] Transcript at 81-86; 354-364. Such an investment was deemed necessary because 50 percent of respondent's sales were made to distributors which, although nominally independent, were in fact controlled by the Tom Huston Peanut Company. Transcript at 110-111, 119-20. Thus, in 1964 taxpayer purchased 10,000 shares of Tom Huston stock at a cost of $380,000, which at the time made respondent between the 10th and 20th largest shareholder in that company. Transcript at 114, 177.

The Commissioner of Internal Revenue assessed and collected from respondent accumulated earnings taxes for the taxable years 1960 and 1961. Thereafter, respondent brought an action for the refund of said taxes in the United States District Court for the Western District of Tennessee. On the basis of the jury's finding that respondent had not

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[1] Petitioner's assertion that respondent's Treasurer first learned of plans to acquire Tom Huston stock in 1963, Brief for Petitioner at 4, n. 4, is misleading. Admittedly there were no definite plans to acquire stock prior to that time, but the Treasurer's testimony indicates clearly that he knew of respondent's desire to purchase such stock for at least 10 years prior to that time. Transcript at 354-364.

accumulated its earnings for the purpose of avoiding tax on its shareholders, the district court entered judgment for respondent. The United States appealed to the Court of Appeals for the Sixth Circuit which reversed on the ground that the district court erred in failing to explain the significance of the phrase "the purpose" when it instructed the jury that the avoidance of taxes on the corporation's shareholder had to be "the purpose" for the accumulation of earnings. Rejecting petitioner's contention that the jury should be instructed that tax avoidance need be only "one of the purposes" for the company's accumulation policy, the court of appeals held that on remand the jury should be instructed that in order for the accumulated earnings tax imposed by Section 531[2] to apply, taxpayer must demonstrate that tax avoidance was not the "dominant, controlling or impelling motive" behind an accumulation of earnings in excess of objectively reasonable business needs.

SUMMARY OF ARGUMENT

Although Section 531 and its predecessors have imposed a tax upon accumulated earnings since the first federal income tax was enacted, and although the phrase "availed of for the purpose" has remained unchanged for these fifty-five years, beginning in 1942 six circuit courts of appeal have evolved three different standards for its application. The Second and Fifth Circuits have held that taxpayer must prove the absence of "any" tax saving motive, without analysis of the causal relationship of such a motive to the accumulation of earnings; the Eighth and Tenth Circuits have held that taxpayer must prove that tax saving was not a "determinating" or "determining" motive for the accumulation; the First and Sixth Circuits, on the other hand, have held that taxpayer must demonstrate that tax saving was not the primary, dominant, controlling or impelling motive for an accumulation of earnings.

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[2]Unless otherwise indicated, references are to the Internal Revenue Code of 1954.

As a practical matter, whenever a closely held corporation accumulates earnings, tax minimization is a known consequence. In petitioner's view this fact of every day life is sufficient to trigger the penalty tax, which would thus apply to every accumulation beyond what are, when viewed with twenty-twenty hindsight, objectively reasonable business needs. The effect of this argument is to eliminate from consideration the subjective elements which, under Section 532(a) must be present prior to the imposition of the surtax.

The standard adopted by the First and Sixth Circuits, unlike that advanced by petitioner, is directed toward the motivating consideration behind taxpayer's conduct. Such an approach is supported by analogy to other areas of the tax law where intent is the ultimate issue and where the statute is silent as to the degree or significance of the motivation. Also, the First and Sixth Circuits' test is most compatible with the competing economic policies involved in the application of the accumulated earnings tax and, in addition, is supported by the statute and is consistent with the legislative history. Finally, the decision of the court below is supported by this Court's opinion in *Helvering v. Chicago Stock Yards Co.*, 318 U.S. 693 (1943), wherein the Court recognized that the relationship between tax saving motives and a decision to accumulate is part of the inquiry under Section 531.

ARGUMENT

THE ACCUMULATED EARNINGS TAX IS APPLICABLE TO UNREASONABLE ACCUMULATIONS OF CORPORATE EARNINGS, UNLESS THE TAXPAYER ESTABLISHES TO THE SATISFACTION OF THE TRIER OF FACT THAT THE DOMINANT, CONTROLLING OR IMPELLING MOTIVE BEHIND THE ACCUMULATION WAS NOT THE AVOIDANCE OF FEDERAL INCOME TAXES WITH RESPECT TO ITS SHAREHOLDERS.

A. THE STATUTORY PATTERN AND EVOLUTION OF THE SECTION 531 TAX

Under Sections 531 and 532(a), a corporation which accumulates its earnings beyond the reasonable needs of its business will be subject to a substantial penalty tax on that portion of its earnings so accumulated provided the corporation was "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders." The statute thus establishes both objective and subjective criteria to test the application of the penalty tax. To the extent that the taxable year's earnings are reasonably required to defray needs for which the taxpayer has specific, definite and feasible plans, susceptible of objective verification, Treas. Reg. § 1.537-1(a), (b) (1960), then to that extent the accumulation will not be subject to the penalty tax, notwithstanding that it may have been prompted solely by tax avoidance motives. *See John P. Scripps Newspapers, Inc.*, 44 T.C. 453 (1965); INT. REV. CODE OF 1954 § 535 (c)(1). *But see, Carolina Rubber Hose Co.,* 24 CCH Tax Ct. Mem. 1159 (1965). However, if the accumulation is found to be in excess of such needs, then to the extent of this excess, such finding is *determinative* of the purpose to avoid the income tax with respect to the corporation's shareholders unless the taxpayer can prove by the preponderance of the evidence to the contrary. INT. REV. CODE OF 1954 § 533(a). Thus, while the ultimate and fundamental area of conflict remains the subjective criteria of intent under the 1954

Code, the war has been waged over the more objective element of business needs owing to the fact that few taxpayers are either prepared or able to satisfy the burden of proof imposed by the statute. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 219-20, 233 (2d ed. 1966).

A tax similar to the one now imposed by Sections 531-537 has played a part in the drama of American business for more than fifty years. The Revenue and Tariff Act of 1913[3] provided that in addition to other taxes, a shareholder would be taxed on his pro rata share of the earnings of a corporation "formed or fraudulently availed of for the purpose of preventing tax on the shareholders." The fact that the corporation was a mere holding company or that earnings were permitted to accumulate beyond the reasonable needs of the business was "prima facie evidence" of a purpose to escape such tax. The Revenue Act of 1916[4] made no material change in the provision. However, the Revenue Act of 1918[5] deleted the word "fraudulently" from the statute. This change was made because of the difficulty in proving fraud.[6]

The decision of this court in *Eisner v. Macomber*, 252 U.S. 189 (1920) prompted Congress in 1921 to impose the tax directly upon the corporation instead of the shareholders. *United Business Corp. v. Commissioner*, 62 F.2d 754, 756 (2d Cir.), *cert. denied*, 290 U.S. 635 (1933); H. R. REP. NO. 350, 67th Cong., 1st Sess. 12 (1921). However, the basic pattern of previous acts was continued in that an accumulation beyond reasonable business needs, while prima facie evidence of a tax avoidance purpose,[7] did not automatically

[3]Ch. 16, § II(a)(2), 38 Stat. 114 (1913).

[4]Ch. 463, § 3, 39 Stat. 758 (1916).

[5]Ch. 18, § 220, 40 Stat. 1057 (1919).

[6]*See* S. REP. NO. 617, 65th Cong., 3d Sess. 5 (1918); 57 Cong. Rec. 253 (1918).

[7]Revenue Act of 1921, § 220, 42 Stat. 247.

trigger the penalty tax since the statute required that "the" purpose of the accumulation must be tax avoidance, thereby permitting taxpayer to introduce other purposes which, if persuasive to the trier of fact, would negate the prima facie case established by the statute. Although an attempt was made in 1928 to enact a mandatory imposition of the surtax whenever undistributed profits exceeded thirty percent of a corporation's net income, dividends and tax-free interest,[8] and although the difficulty of proving the specific purpose for the accumulation had rendered the provision more or less ineffective,[9] it continued substantially unchanged until 1938.[10]

In 1938, Congress became concerned with the difficulties encountered by the Commissioner in connection with proof of the element of intent to avoid tax.[11] These difficulties were highlighted by two decisions, *National Grocery Co. v. Helvering*, 92 F.2d 931 (3rd Cir. 1937) and *Commissioner v. Cecil B. DeMille Prods., Inc.*, 90 F.2d 12 (9th Cir. 1937), in which the taxpayers avoided application of the tax by minimal showings of non-tax purposes. Section 102 of the Revenue Act of 1938[12] was an attempt to remedy this situation. It continued the "prima facie evidence of a purpose" test with respect to holding or investment companies,[13] but made an accumulation beyond reasonable busi-

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[8]*See* 69 Cong. Rec. 519, 7977 (1928).

[9]H. R. REP. NO. 2475, 74th Cong. 2d Sess. 5 (1936). In fact, the statute was virtually unused until after 1930. Canty, *The Accumulated Earnings Tax 1954 Reform, An Appraisal*, 2 U. SAN FR. L. REV. 242 (1968).

[10]*See* Revenue Act of 1924, § 220, 43 Stat. 277; Revenue Act of 1926, § 220, 44 Stat. 34; Revenue Act of 1928, § 104, 45 Stat. 814; Revenue Act of 1932, § 104, 47 Stat. 195; Revenue Act of 1934, § 102, 48 Stat. 702; Revenue Act of 1936, § 102, 49 Stat. 1676.

[11]*See* H. R. REP. NO. 1860, 75th Cong., 3d Sess. 20 (1938).

[12]52 Stat. 483.

[13]The application of the accumulated earnings tax to holding and investment companies had been rendered academic, at least with

ness needs "determinative of the purpose" to avoid the surtax upon its shareholders unless the corporation by the clear preponderance of the evidence proved to the contrary.[14] In considering the problems of implementation faced by the Commissioner, Congress did not amend the statute to require the tax to apply in those situations where a corporation was formed or availed of for "a" purpose to avoid tax. Rather, it chose to strengthen the presumption created by an unreasonable accumulation by making such a finding "determinative" of the forbidden purpose, and accordingly, the tax applied unless the taxpayer could demonstrate by a preponderance of the evidence that such accumulation was not for "the" purpose of tax avoidance.

Although there were efforts to limit the impact of Section 102,[15] no such changes were effected from 1939 to 1954, and during this period enforcement of the penalty tax provisions was considerably heightened.[16] As a result of the government's vigorous enforcement of these provisions and the success achieved, Congress received numerous complaints to the effect that Section 102 was prejudicial to small business; that it was applied in an arbitrary manner in many cases and was used by revenue agents as a threat to induce settlement on other issues. As a result, Section 102 was considered by many as a constant threat to expanding busi-

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respect to "incorporated pocketbooks," by passage of the personal holding company tax in 1934. *See* S. REP. NO. 1567, 75th Cong., 3d Sess. 4 (1938).

[14]On February 10, 1939, this provision was adopted as Section 102 of the Internal Revenue Code of 1939, 53 Stat. 35 (1939).

[15]*See* H. R. 6712, 80th Cong., 2d Sess. (1948); H. R. 961, 80th Cong., 1st Sess. (1948).

[16]During the period 1939-52, there were 68 reported cases under Section 102. JOINT COMMITTEE ON THE ECONOMIC REPORT, THE TAXATION OF CORPORATE SURPLUS, 82nd Cong., 2d Sess. 5 (1952) (hereinafter "JOINT COMMITTEE"). *See also Id.* at 109.

ness enterprises.[17] The 1954 Code thus contained various provisions to ameliorate the application of the penalty tax, including, under certain circumstances, a shift in the burden of proof as to the grounds for the accumulation from the taxpayer to the Commissioner;[18] elimination of the so-called "immediacy test" for business needs;[19] and the adoption of an accumulated earnings credit which limited the tax's application to accumulated earnings in excess of $60,000 (now $100,000), or the reasonable needs of the business, whichever was greater.[20] The 1954 amendments did not, however, eliminate the opportunity previously afforded the taxpayer, difficult as it was, to negate the determination that an objectively unreasonable accumulation of earnings was made for the prohibited purpose.

B. JUDICIAL ANALYSIS OF THE PHRASE "THE PURPOSE" AS IT APPEARS IN SECTION 532(a)

The meaning of the term "the purpose" appearing in Section 532 was first considered by an appellate court in *Chicago Stock Yards Co. v. Commissioner,* 129 F.2d 937 (1st Cir. 1942), *rev'd on other grounds,* 318 U.S. 693 (1943). Although the issue was not squarely presented, the court rejected the dictum enunciated in *R.L. Baffer Co.,* 37 BTA 851, 856, *aff'd,* 103 F.2d 487 (5th Cir.), *cert. denied,* 308 U.S. 576 (1938), wherein the Board of Tax Appeals stated that in order to escape the penalty, taxpayer must demonstrate that its purpose for the accumulation was "wholly other" than tax saving. Instead, the First Circuit adopted the position that the forbidden motive must have played a substantial part in inducing the accumulation. Sub-

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[17] S. REP. NO. 1622, 83rd Cong., 2d Sess. 68 (1954); H. R. REP. NO. 1337, 83rd Cong., 2d Sess. at 51-52 (1954).

[18] INT. REV. CODE OF 1954, § 534.

[19] INT. REV. CODE OF 1954, § 537.

[20] INT. REV. CODE OF 1954, § 535.

sequently, in *Young Motor Co. v. Commissioner*, 281 F.2d 488 (1st Cir. 1960), the First Circuit refined its position in *Chicago Stock Yards Co.*, and held that for the tax to apply, tax avoidance must be the primary or dominant purpose leading to the decision to accumulate earnings.

The next appellate court to consider the issue was the Second Circuit in *Trico Prods. Corp. v. Commissioner*, 137 F.2d 424 (2d Cir.), *cert. denied*, 329 U.S. 799 (1943). In this case, the Board of Tax Appeals held that taxpayer must carry the burden of proving the complete absence of a tax avoidance motive. *See Trico Prods. Corp.*, 46 BTA 346, 374 (1942). Without attempting to analyze the issue, the Second Circuit affirmed on the basis of a quotation from this Court's opinion in *Helvering v. Chicago Stock Yards Co., supra.*[21]

The Tenth Circuit in *World Publishing Co. v. United States*, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949), and the Eighth Circuit in *Kerr-Cochran, Inc. v. Commissioner*, 253 F.2d 121 (8th Cir. 1958), although relying on the Second Circuit's opinion in *Trico Prods. Corp.*, adopted a construction which appears to differ from that of both the First and Second Circuits. *See Canty, supra* n.9, at 250-51. These courts held that taxpayers must demonstrate that the purpose to avoid taxes is not one of the "determinating" (Eighth Circuit) or "determining" (Tenth Circuit) purposes. *See also, E-Z Sew Enterprises, Inc. v. United States*, 260 F. Supp. 100, 120 (E.D. Mich. 1966).

In *Barrow Mfg. Co. v. Commissioner*, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962), the Fifth Circuit, in adopting the theory previously enunciated by the Tax Court and the Second Circuit, made the first analytical attempt to justify the "any purpose" test. The court mistakenly reasoned that the utility of the presumption arising from the accumulation of earnings beyond the objectively reasonable needs of the business would be destroyed if

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[21] See note 24, *infra*.

"saddled with requirement of proof of the 'primary or dominant purpose' of the accumulation." 294 F.2d at 82. Finally, in the instant case, the Sixth Circuit adopted the basic position taken by the First Circuit in *World Publishing Co.*, and held that in order to avoid the penalty of Section 531, the taxpayer must demonstrate that tax saving was not the dominant, controlling or impelling motive behind its accumulation of earnings.[22]

C. THE "ANY PURPOSE" TEST IS INCONSISTENT WITH THE DECISIONS OF THIS COURT, AND THE STATUTE AND IMPLEMENTING REGULATIONS, AND IS NOT SUPPORTED BY THE LEGISLATIVE HISTORY

1. The issue before this Court is whether, and if so, to what extent, a tax-saving motive must influence or induce the failure to distribute earnings in excess of objectively reasonable business needs before the penalty tax of Section 531 can be applied. Put in terms of statutory context, this Court must decide whether a taxpayer, in order to prevent application of the penalty tax, must demonstrate that tax saving considerations did not play a substantial, significant or controlling role in influencing an excess accumulation of earnings or whether taxpayer must demonstrate the complete absence of tax saving considerations in its decision to accumulate.

The position of petitioner herein is that, assuming a taxpayer has one hundred[23] valid reasons or purposes for accumulating its earnings beyond its objective business needs, then notwithstanding these reasons or purposes, if the corporate managers also desired to minimize tax at the shareholder level, the statute is satisfied and the penalty tax applies without any consideration of the extent, if any, to which this desire to minimize tax influenced the final

[22]Petitioner's suggestion that for seventeen years after this Court's decision in *Chicago Stock Yards Co.*, the law in this area was clearly settled in its favor, Brief for Petitioner at 26, is erroneous. *See* TAX INSTITUTE, ECONOMIC EFFECTS OF SECTION 102, 201 (1951).

[23]Record at 47.

decision to accumulate rather than distribute. Such a position, while apparently adopted by the Tax Court and the Second and Fifth Circuits, is inconsistent with the Court's opinion in *Helvering v. Chicago Stock Yards Co.*, *supra*. Although the Court did not squarely address itself to this issue,[24] it did note that a subsequent tax saving motive may "induce or aid in inducing" the continuation of a practice theretofore adopted solely for non-tax reasons. Thus, the Court recognized that for the tax to apply, there must be a causal relationship between the tax saving motive and the decision to accumulate.[25] The rationale of the

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[24]In this case, Mr. Justice Roberts noted that

> A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice.

318 U.S. at 699. As the court below noted,

> It would greatly strain the court's remarks to conclude that on so employing the parenthetical phrase "or aided in inducing," it was considering the important question here posed, that is to say, whether the purpose to avoid income tax need be the dominant, controlling or impelling purpose.

Record at 58; *Accord*, Canty, *supra*, n. 9, at 250. In *Chicago Stock Yards Co.*, the Board of Tax Appeals found that the sole purpose of the company's retention of earnings was tax avoidance. 41 BTA 621. In this Court, the central issue was the sufficiency of the evidence to sustain the Board's finding. The other issue, in connection with which the cited language was used, was whether what was originally a non-tax arrangement could be turned into a tax-avoidance device.

In connection with the passage from *Chicago Stock Yards Co.*, quoted above, petitioner asserts at pages 25-26 of its brief that the application of the Section 531 tax does not depend upon a significant change in corporate practices. *But see United Business Corp.*, 19 BTA 809, 828 (1930), *aff'd*, 62 F.2d 754 (2d Cir.), *cert. denied*, 290 U.S. 635 (1933).

[25]*See also* B. BITTKER & J. EUSTICE, *supra* at 216.

Court's decision thus clearly supports both in principle and logic the decision of the Sixth Circuit and, contrary to petitioner's plea, does not support the "any" purpose test.

Petitioner's refusal to weigh the influence of tax minimization upon the decision to accumulate appears all the more unwarranted if calculations showing how much tax was saved to the shareholder are considered as evidence of purpose. Under petitioner's proposal, the penalty tax would apply even if the tax saving to the shareholders was de minimis and the purpose to effect such saving was insignificant in comparison with other reasons for the accumulation.

Moreover, it is an accepted principle of tax law that an otherwise bona fide transaction will not be tainted merely because of a subsidiary tax saving purpose. *Gregory v. Helvering,* 293 U.S. 465, 469 (1935); *Goldstein v. Commissioner,* 364 F.2d 734, 741 (2d Cir. 1966), *cert. denied,* 385 U.S. 1005 (1967); *see Commissioner v. Brown,* 380 U.S. 563 (1965). Consequently, the mere presence of a tax saving purpose should not precipitate application of the Section 531 tax without any analysis of its relationship to the accumulation.

2. In a curious play on words with a view to avoiding any meaningful construction of the statute, petitioner suggests that since every corporation is formed or availed of for multiple corporate purposes and since tax saving is invariably one of the considerations involved in the utilization of a corporation, the statutory purpose is automatically satisfied in those situations where a corporation accumulates earnings beyond the objectively reasonable needs of the business. Brief for Petitioner at 11-13. Under petitioner's theory, every corporation is availed of for tax avoidance purposes, and accordingly, the only inquiry which need be made is whether or not an accumulation exceeds the objectively reasonable needs of the business. If an accumulation is in excess of this standard, then no further inquiry need be made and the tax applies. This simplistic approach results not in a "construction" of the statute but rather the

elimination of that portion of the statute which requires the accumulation to be motivated by tax avoidance purposes prior to the application of the penalty tax.

It is axiomatic that operating a profitable business in corporate form inherently permits the retention of all or a portion of the corporation's earnings. Whether the interposition of a corporate entity will result in greater or lesser tax to the Treasury depends on numerous factors including the rates of tax on corporations and individuals and the deductions available in any given year to either the corporation or individual. Undoubtedly, in organizing a corporation, the owners or business managers recognize that tax benefits may necessarily flow therefrom, especially in those situations where the individual taxpayer's bracket is greater than that of the corporation. Normally, however, a multitude of factors unrelated to tax consequences motivates the use of the corporate entity, *e.g.*, insulation of the owner against tort liability; protecting the owner's other assets from the risk of the business conducted by the corporation; permitting more efficient and centralized operation of the business; permitting the corporation to take advantage of the various pension, profit sharing and stock option provisions of the Internal Revenue Code of 1954, as amended; facilitating financing arrangements; and permitting a more orderly disposition of the business through gifts and transfers of stock.

The fact that tax savings is one of the purposes in causing individuals to utilize the corporate entity has never caused the corporation to be ignored for tax purposes or tainted the corporation for purposes of applying the various provisions of the Internal Revenue Code. Carried to its logical conclusion, petitioner's view would demand that every corporation be tainted for purposes of the unreasonable accumulation provisions since by its very nature it is formed or availed of for tax savings. Consequently, every accumulation in excess of the objectively reasonable needs of the business would be subject to the penalty.

The officers and directors of a closely held corporation[26] can be presumed to know the resulting tax consequences to themselves or, if they are not in control, to the controlling shareholders if earnings are distributed as dividends: absent offsetting deductions, income tax will be payable. Certainly, if a taxpayer understands the tax laws, it seems only reasonable that tax minimization will occupy some of his thinking. As the First Circuit noted in *Young Motor Co.*, to the extent that tax savings are a necessary result of an accumulation, they are a contemplated consequence thereof.[27] Thus, as a practical matter, under petitioner's theory, knowledge of the tax benefits to be derived would be sufficient to carry the day.[28] Obviously, this is not the purpose at which the statute was directed.

By seeking to prevent consideration of the relationship between tax saving motives and the decision to accumulate earnings, petitioner attempts to limit the scope of the inquiry in applying the Section 531 tax to the objectively reasonable needs of a corporation's business. In support of its position, petitioner argues that once it is shown that earnings have been accumulated beyond the reasonable needs of the business, there is no credible objective evidence of proper motives.[29] However, Congress has previously considered and

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[26] As a general rule, the tax is imposed only on closely held corporations. *See* H. R. REP. NO. 1337, *supra* n. 17, at 54. Although in *Trico Prods. Corp.*, *supra*, there were 2,000 shareholders, 70 percent of the stock was owned by a small group.

[27] 281 F.2d at 491.

[28] *See Id.;* Record at 46-47.

[29] *See* Brief for Petitioner at 18-21. This argument, however, confuses objective evidence with objectively definite and fixed business needs of the variety for which a credit can be obtained under Section 535. Obviously, taxpayer's reasons for an accumulation of earnings beyond what is needed in its business would have to be established to the satisfaction of the trier of fact. *See, e.g., Bremerton Sun Publ. Co.*, 44 T.C. 566 (1965).

rejected a wholly objective approach[30] and while the 1954 amendments have reduced the significance of the subjective factors, these amendments were intended to benefit the taxpayer in facing the threat of the penalty tax, not to prejudice him as petitioner implies.

Furthermore, the Treasury's own regulations require that such an inquiry be made. Thus, Section 1.533-1(a)(2) provides that the existence or non-existence of the purpose to avoid income tax with respect to shareholders depends upon the particular circumstances of each case, including dealings between the corporation and its shareholders, the investment by the corporation in assets having no reasonable connection with the business of the corporation, and the dividend policy of the corporation. The purpose of the regulations is to set forth certain criteria with a view to establishing the principal and dominating motives of the taxpayer. Thus, assuming the absence of corporate loans to shareholders and unrelated corporate investments and a reasonable dividend policy, the obvious inference to be drawn is that the conduct of the taxpayer in withholding earnings was not principally motivated by tax avoidance purposes. Accordingly, the regulatory scheme seeks to determine the dominant and controlling factors of behavior by requiring an analysis of multiple transactions, any one of which may be indicative of taxpayer's ultimate purpose.

The result of petitioner's per se position is to read out of the statute the phrase "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders." The insidiousness of the petitioner's position is further aggravated by the fact that the Treasury in its day-to-day application of the credit provisions of Section 535(c) has attempted to limit severely the scope and extent of taxpayer's business needs. *E.g.*, Brief for Respondent at 34-37, Reply Brief for Respondent at 11, *John P. Scripps Newspapers, Inc., supra.* As a result, the application of the Sec-

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[30] See text at footnote 8, *supra*.

tion 531 tax, at least at the revenue agent level, is determined by reference to liabilities appearing on the balance sheet and obligations under written commitments. Although some relief might be obtained on review, the cost of litigation frequently proves to be an insurmountable obstacle to the small taxpayer.[31] While there may be some merit in this procedure in terms of ease of administration, it is clearly and wholly repugnant to the statutory pattern.

For an example of the consequences flowing from the government's interpretation of the statute, the Court is respectfully referred to *The Shaw-Walker Co.*, 24 CCH Tax Ct. Mem. 1709 (1965), *rev'd*, 390 F.2d 205 (6th Cir. 1968), *petition for cert. filed*, 36 U.S.L.W. 3444 (U.S. May 13, 1968) (No. 1431, 1967 Term; renumbered No. 95, 1968 Term). In this case, the Tax Court found that the corporation did not syphon off earnings in disguised form by loaning money to or providing luxuries for its shareholders; that there were no investments in unrelated businesses; and that during the years at issue between 43.1 percent and 33.9 percent of net after tax income was distributed in dividends, which distributions were established by uncontradicted evidence to be in excess of average industry distributions. See Brief for Appellant at 65-67, *Shaw-Walker Co. v. Commissioner*, 390 F.2d 205 (6th Cir. 1968).

Although the taxpayer thus measured favorably against the most significant criteria for determining intent, as set forth in Section 1.533-1(a)(2) of the Regulations, and although taxpayer's principal witness, whom the Tax Court found to be "extremely cooperative" and a witness whose "honesty has impressed me," Record at 398a, testified that the company was not used to avoid tax and that its affairs were managed

[31] S. Rep. No. 1622, *supra* n. 17, at 70-71; H. R. Rep. No. 1337, *supra* n. 17, at 52, 54. In the instant case, respondent seeks refunds of approximately $35,000 in tax. In connection with this recovery, taxpayer has been involved in proceedings before a district court, a court of appeals and now the Supreme Court; and, notwithstanding the disposition by this Court, will again be involved in litigation in the district court.

for the sole purpose of maintaining the company as a sound going enterprise, Record at 374a, 393-95a, the Tax Court held that notwithstanding this evidence, taxpayer had not met its burden of proof on the issue of intent. In holding for the Commissioner in this case, the Tax Court relied solely upon the presumption of Section 533 and the fact that during each of the years in issue the majority shareholder was in a very high income tax bracket. In effect, the Court held that if earnings are accumulated beyond objective business needs, and if the principal shareholders are subject to a high rate of tax, the Section 531 tax applies.

3. Petitioner maintains that its position is conclusively supported by the legislative history of Sections 531-537. Initially, it notes that prior to 1938 the predecessor to Section 533(a) made an unreasonable accumulation "prima facie evidence of *a* purpose to avoid surtax," although the taxing provision was addressed to corporations "availed of for *the* purpose." Petitioner then argues that the definite article "the" could hardly have been intended to control application of the statute when the companion evidentiary section used the indefinite "a" at the parallel point.[32] Petitioner's argument, however, will not wash because it fails to recognize the significance of Congress' use of the article "a" in the evidentiary section of the statute and the article "the" in the operative part of the statute. The operative provisions provide that the penalty will only result in those situations where the corporation was availed of for the purpose of avoiding income tax with respect to its shareholders. The evidentiary portion of the statute made an unreasonable accumulation "prima facie" evidence of *a* purpose to avoid surtax upon shareholders. An unreasonable accumulation, which was deemed prima facie evidence of *a* purpose, shifted the burden to the taxpayer to show that although tax saving was a purpose for the accumulation it was not *the* purpose motivating the accumulation.

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[32] Brief for Petitioner at 16.

Accordingly, the evidentiary section of the statute required the conclusion that an excess accumulation would render the penalty applicable unless taxpayer could demonstrate some non-tax reason for its failure to distribute earnings. Once such a non-tax reason was introduced, the Commissioner's prima facie case was negated. However, if taxpayer failed to introduce evidence to counter the prima facie presumption, the inferred purpose would be deemed "the purpose" and the penalty tax would apply by virtue of taxpayer's failure of proof. This analysis of the statute is supported by the contemporaneous expression that the "prima facie evidence" provision did no more than make the taxpayer show its hand. *United States v. R. C. Tway Coal Sales Co.*, 75 F.2d 336, 337 (6th Cir. 1938); *United Business Corp. v. Commissioner, supra* at 756. Moreover, it was the inefficacy of the former provision and the ease with which the presumption could be avoided, spotlighted by *National Grocery Co., supra*, and *Cecil B. DeMille Prods., Inc., supra*, which led to the language currently found in Section 533(a).

Contrary to petitioner's argument, Congress was well aware of the distinction it was making in the statute and if it intended to adopt the "any" purpose test suggested by the petitioner, it could have simply used the article "a" instead of "the" in the operative portion of the statute. The fact that it deliberately chose not to do so is ample testimony to the fact that Congress intended "the purpose" to be the dominant, motivating and controlling reason for the accumulation for the penalty tax to apply.

Curiously, petitioner contends that the statute from the very beginning required and was uniformly interpreted as requiring only "a" purpose of tax savings on the part of the taxpayer for the statute to apply. However, the 1938 amendment did not change the operative provision of the statute, "availed of for the purpose"; it merely effected a change in the presumption. Thus, instead of an excess accumulation being "prima facie evidence" it was determinative evidence of the tax avoidance purpose. If, as peti-

tioner contends, the statutory purpose was historically satisfied by a showing of tax savings alone, notwithstanding a multitude of non-tax reasons, it is difficult to envision that a change in the presumption would cause any change in the tax result since it is the government's view that all that was required for the tax to apply was an excess accumulation coupled with knowledge of the tax savings to the shareholders as a result of the accumulation at the corporate level. The success which the government enjoyed in this area subsequent to the 1938 amendment occurred because the introduction of the determinative presumption imposed a most difficult burden on the taxpayer in its effort to show that the dominant, controlling and compelling reason for the accumulation was not for the purpose of tax avoidance, not because the statute provided that tax savings alone was sufficient to cause the surtax to apply.

In support of its legislative history argument, petitioner also cites[33] an excerpt from the Congressional reports on the Revenue Act of 1938, which described the change from "prima facie evidence" to "determinative" as

> requiring the taxpayer by a clear preponderance of the evidence to prove the absence of any purpose to avoid surtaxes upon the shareholders after it has been determined that the earnings and profits have been unreasonably accumulated.[34]

This off-hand reference, however, does not indicate that Congress actually deliberated upon the significant issue presented herein, and the absence of discussion in the hearings or during floor debate confirms the view that such was not the case. The aforementioned quotation is all the more gratuitous in view of the fact that the Revenue Act of 1938 made no change in the operative taxing phrase which is be-

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[33] Brief for Petitioner at 17.

[34] H. R. REP. NO. 855, 76th Cong., 1st Sess. 6 (1939); S. REP. NO. 1567, *supra* n. 13 at 4-5.

fore the Court in this case, since Section 533(a) and its predecessors are and were merely aids to the Commissioner in proving the element of intent, enacted more than twenty years after the birth of the taxing phrase itself. As this Court has held on numerous occasions, the views of one Congress as to the construction of a statute adopted many years prior by another Congress have very little, if any, significance. *E.g., United States v. Southwestern Cable Co.*, __ U.S. __, 88 S. Ct. 1995, 2001 (1968).

In a final effort to persuade this Court that Congress intended to have the surtax apply if tax savings is one of the purposes for an accumulation beyond the objectively reasonable needs of the business, petitioner refers to Section 535(c).[35] The relevance of this section to the argument advanced by petitioner is difficult to comprehend in view of the fact that this section was intended to insulate the corporation from the surtax in circumstances where either the accumulation was not beyond the reasonable objective needs of the business but, in fact, was principally motivated for tax avoidance purposes or where the portion of an accumulation which was primarily and principally for tax avoidance, tainted the portion accumulated for objectively reasonable needs of the business.

Under the 1939 Code and previous revenue acts, the tax would be imposed where the subjective motive for an accumulation was tax savings, notwithstanding that the accumulation did not exceed the objective needs of the business. *See, e.g., United States v. R. C. Tway Coal Sales Co., supra;* Treas. Reg. 118, § 39.102-2 (1953). As the First Circuit noted in *Chicago Stock Yards Co.*, although

> the accumulation may have been within the reasonable needs of the business judged by objective standards, the other evidence might indicate that the directors, in deciding to withhold the distribution of dividends,

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[35] Brief for Petitioner at 17-18.

> were concerned not so much with providing for business needs (as to which, as a matter of judgment, they may have been in doubt), as with the desire to avoid heavy surtaxes to the shareholders.[36]

Moreover, if part of the accumulation was made for tax saving reasons, the whole accumulation was taxed, because under Section 102 of the 1939 Code, the tax was upon "undistributed Section 102 income," which included all accumulated earnings.

Apparently, petitioner reasons that since Section 535(c) was intended to eliminate the surtax to the extent that demonstrable business needs justify the accumulation without any necessity of inquiry into the subjective element for any portion of the accumulation, any accumulation beyond such needs is to be taxed under Section 531. Alternatively, petitioner suggests that "[T]he simultaneous presence of other motives at most serves to reduce the tax through application of the credit provisions of Section 535(c)." Brief for Petitioner at 10. Petitioner's analysis confuses the objective and subjective elements of Sections 531-537 and their predecessors. Initially, it must be remembered that Section 535(c) was enacted as a benefit to the closely held corporation in that it made clear that any accumulation which did not exceed the objective needs of the business would not be subject to the tax notwithstanding taxpayer's motive for this accumulation. Secondly, it provided that if a portion of the accumulation could be justified in terms of objective business needs, such portion would not be subject to the tax notwithstanding that the remainder of the accumulation was principally and dominantly motivated by tax avoidance purposes. In adopting the accumulated earnings credit of Section 535(c), Congress was interested in excluding from the application of the penalty tax those earnings not in excess of objectively reason-

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[36] 129 F.2d 950. *Accord, Young Motor Co. v. Commissioner, supra* at 491; *see R. Gsell & Co. v. Commissioner*, 294 F.2d 321 (2d Cir. 1961).

able business needs, notwithstanding the subjective motive for the accumulation and thus, eliminating both uncertainty and the necessity for a searching and costly inquiry in these situations.[37] Under no circumstances was Section 535(c) intended to, nor did it eliminate the opportunity of taxpayer to show by a preponderance of the evidence that an accumulation beyond its objective business needs was not principally motivated by tax avoidance purposes.

D. THE "DOMINANT, CONTROLLING OR IMPELLING MOTIVE" STANDARD IS CONSISTENT WITH THE STATUTORY PROVISIONS, IS SUPPORTED BY ANALOGY TO OTHER PROVISIONS WITH SIMILAR PURPOSES, AND CONSTITUTES A REASONABLE RESOLUTION OF THE CONFLICTING POLICIES AFFECTING APPLICATION OF THE SECTION 531 TAX.

Clearly, in order for the accumulated earnings tax to be applicable, the tax saving motive must have played an effective part in the decision to accumulate rather than distribute corporate earnings. If taxpayer can convince the trier of fact that earnings would have been retained even if a distribution would not have been taxable to its shareholders, the penalty tax should not apply. The question remains as to the terms in which this standard should be enunciated. It is submitted that the criteria of the First and Sixth Circuits are best adapted to the task.

1. If read literally, Section 532 and the parallel language of Section 535(c)(1) could be taken to demand that for the tax to apply, tax saving motives must be the sole purpose for an accumulation of earnings. Because human conduct is seldom motivated solely by a single impulse, such a construction would severely cripple the statute. Consequently, this interpretation was rejected by the court below. Record at 59. *See also* B. Bittker & J. Eustice, *supra* at 216. Nevertheless, Section 532(a) uses the phrase "availed of for the

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[37] *See* S. Rep. No. 1622, *supra* n. 17, at 71-72.

purpose"; it does not provide that the tax will apply where the corporation was "availed of for a purpose" of tax saving. If Congress had desired to impose the tax if "one of the motives" for the accumulation was tax reduction, it certainly was capable of so providing. Similarly, petitioner notes[38] that Congress could also have provided, but did not that the tax would be applied where the corporation was "availed of principally for the purpose" or where it was "formed or availed of for the principal purpose" of tax saving. It is submitted, however, that use of the definite article "the" rather than the indefinite "a" which originally appeared in the evidentiary provision, supports respondent's position and the First Circuit in *Young Motor Co.* so held. *Cf., Malat v. Riddell,* 383 U.S. 569 (1966).

2. In support of its conclusion, the court below relied principally upon analogy to other instances in the tax law where motivation is the relevant consideration in determining the tax consequences of an individual's conduct, and where the degree or significance of the motivation factor is not detailed by the statute. Initially, as this Court has consistently held, in order for property transferred during a decedent's lifetime to be included in his taxable estate as a transfer "in contemplation of his death" under Section 2035, the death motive must be the dominant, controlling or impelling motive behind the transfer. In *Allen v. Trust Co. of Georgia,* 326 U.S. 630 (1946), the government argued that a transfer was in contemplation of death if motivated by a purpose to avoid the estate tax, as such a motive would cause a decedent to make an inter vivos transfer rather than a will. Thus, the government reasoned that the statute, which was intended to prevent evasion of the estate tax by inter vivos transfers, *United States v. Wells,* 283 U.S. 102, 112 (1931), is satisfied by mere presence of this consideration. The Court, however, rejected this simplistic ap-

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[38] Brief for Petitioner at 12-13.

proach. Every donor knows that property given away will not be included in his estate when he dies. 326 U.S. at 635. The estate tax saving through inter vivos transfers is readily apparent to any sophisticated donor and can be presumed at least to have entered his consideration. Nevertheless, this alone is not sufficient to excite application of Section 2035. Once the tax saving factor is introduced, a further analysis must be made to determine its significance upon the decision to make the transfer. Put in its statutory context, it is presumed that the dominant, controlling or impelling motive behind every transfer within three years prior to the date of death was estate tax saving, or another death-related factor, unless "shown to the contrary."

The court below also considered persuasive this Court's reasoning in *Commissioner v. Duberstein*, 363 U.S. 278 (1960). In *Duberstein*, the Court was called upon to set forth the circumstances under which a transfer of property is excludable from the gross income of the recipient as a gift, under the predecessor to Section 102(a). Recognizing that the ultimate issue was the intent with which the transfer was made, the Court held that the yardstick for determining whether a transfer is taxable as income, or nontaxable as a gift, is its basic motivation; the dominant reason explaining the transferor's action in making the transfer. Thus, in order to escape tax under Section 102(a) the taxpayer must prove that the dominant or basic motive for the transfer of property to him was the "detached and disinterested generosity" of the donor.[39]

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[39] Petitioner relies upon *Duberstein* for an entirely different reason. See Brief for Petitioner at 15. In its opinion the Court noted that

> The exclusion of property acquired by gift from gross income under the federal income tax laws was made in the first income tax statute passed under the authority of the Sixteenth Amendment, and has been a feature of the income tax statutes ever since. The meaning of the term "gift" as applied to particular transfers has always been a matter of contention. Specific and illuminating legislative history on the point does not appear to

Petitioner, on the other hand, would analogize to Section 7201, imposing criminal penalties upon attempts to evade or defeat the tax.[40] This section will apply if tax evasion motives play any part in affirmative conduct, the likely effect of which is to mislead or conceal. *Spies v. United States,* 317 U.S. 492, 499 (1943). *But see Marchetti v. United States,* 390 U.S. 39 (1968). While the tax of Section 531 is a "penalty" in the generic sense, and thus should be strictly construed, *see United Business Corp., supra* n. 24, because of their different purposes a basic distinction must always be maintained between criminal and civil penalties, *see Helvering v. Mitchell,* 303 U.S. 391, 404 (1938). Section 7201 contemplates government proof beyond a reasonable doubt of affirmative actions of misrepresentation or concealment, with the specific intent to evade tax; that is, knowledge and evil intent, a purpose to do wrong. *Holland v. United States,* 348 U.S. 121 (1948); *United States v. Murdock,* 290 U.S. 389 (1933). Section 7201 is, in the last analysis, aimed at conduct which, if permitted, would undermine the major source of revenue for the federal government.

Section 531, on the other hand, does not require that the government prove beyond a reasonable doubt that

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> exist. Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious. See Lockard v. Commissioner, 1 Cir., 166 F.2d 409.

363 U.S. 284. From this, petitioner concludes that the Sixth Circuit's consideration of the cases under Sections 2035 and 102 is immaterial. However, analysis of the passage as a whole, instead of the single sentence quoted by petitioner, indicates that the Court was addressing itself to the peculiar issue with which it was confronted, and was not laying down a dictum of general application in the tax field. This analysis is confirmed by the Court's reference to *Lockard v. Commissioner,* 166 F.2d 409 (1st Cir. 1948) in which the court held that merely because a transfer of property does not shift the onus of tax upon the income therefrom, this does not mean that it does not constitute a taxable gift; that is: the gift and income tax provisions of the Internal Revenue Code are not in *pari materia.*

[40] See Brief for Petitioner at 15 n. 10.

tax savings was the purpose for the accumulation. Rather, the statute places a most difficult burden on the taxpayer to establish the purpose of the accumulation. Unlike Section 7201, no affirmative act of concealment or misrepresentation is involved in a Section 531 case, since the information required to bring this provision into play is spread upon the tax returns, and readily available for examination. Nor is the element of evil purpose or wrongdoing involved in a Section 531 case. Finally, the conduct at which Section 531 is aimed is clearly dissimilar to that prescribed in Section 7201.

In attempting an analytical approach to the application of Section 532(a), the Fifth Circuit in *Barrow Mfg. Co. v. Commissioner, supra,* reasoned that the utility to the Section 533(a) presumption arising from an accumulation of earnings beyond the objectively reasonable needs of its business would be destroyed if "saddled with the requirement of proof of 'the primary or dominant purpose' of the accumulation." 294 F.2d at 82. See Brief for Petioner at 23-24. This analysis completely misconstrues the effect of Section 533(a). The evidentiary and taxing sections clearly are conterminous, so that taxpayer would be called upon to convince the trier of fact that the dominant, controlling or impelling motive behind an "excess" accumulation was not the avoidance of tax upon its shareholders.

4. Although a person's activities are seldom the result of a single purpose or motivating impulse, generally there will be some one factor which tips the balance in favor of one alternative and against the other, or without which a particular decision would not be made. *Cf., Commissioner v. Duberstein, supra* (basic reason). By establishing a standard in terms of a search for the dominant, controlling or impelling motive behind a decision to accumulate the court below has effected a reasonable compromise between the conflicting policies inherent in the application of Section 531; the production of revenue through the distribution of taxable dividends on the one hand, and on the

other the protection and stimulation of competition in the marketplace.

The first tax on accumulated earnings, enacted at a time when corporate earnings were not taxed, was aimed at preventing the total avoidance of federal income taxes upon corporate earnings. While the tax is not productive of substantial revenues,[41] it is likely that the threat of its imposition has caused payment of dividends which otherwise would not have been declared. Due to the present high rate of tax upon corporate earnings, however, the safeguard against tax avoidance found in Section 531, while of continuing necessity,[42] is no longer of the same crucial importance in terms of federal revenues.

Contemporary economics would recognize a distinction between a corporation's savings (bank accounts and marketable securities) which do not increase the flow of spendable income and thus stimulate buying, and investments (principally inventory and fixed assets) which do make economic contribution through the creation of jobs.[43] Thus, the continued virility of the Section 531 tax can be partially justified as a deterrent to corporate saving and as an inducement to corporate expansion and, in fact, empirical studies have shown that the tax does have this effect.[44]

It appears to be generally accepted that, to an appreciable extent, the Section 531 tax stimulates the acquisition of small businesses by larger ones. *See, e.g.*, S. SURREY & W. WARREN, FEDERAL INCOME TAXATION, 1405 (1962). The constant threat of a Section 531 deficiency and the expenditure of time and effort involved in defending against the

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[41] JOINT COMMITTEE at 109, 154-56.

[42] S. REP. NO. 1622, *supra* n. 17, at 68.

[43] An excess of saving over investment is credited as a primary cause of the great depression of 1929. A. HANSEN, BUSINESS CYCLES AND NATIONAL INCOME, Ch. 5, and at 334-43 (2d ed. 1964); R. PAUL, TAXATION IN THE UNITED STATES 266-84 (1954).

[44] JOINT COMMITTEE at 36.

challenge under Section 531 are important factors inducing successful closely held corporations to sell to or merge with public corporations. Although the 1954 amendments were intended to provide relief in this area, the substantial volume of accumulated earnings tax cases,[45] and this Court's consideration of the question at issue, combined with the current merger spiral, testify eloquently to the continuing pressures exerted by Section 531 upon closely-held businesses. The Section 531 tax, then, should be construed in a manner which does not do violence to the principles of competition and which is consistent with its basic economic purposes. As the Second Circuit noted in *Electric Regulator Corp. v. Commissioner*, 336 F.2d 339, 346 (2d Cir. 1964), Congress' desire to prevent abuse through the use of private or closely-held family-owned corporations must be balanced with its desire to stimulate and encourage the economic growth of the smaller units of industry.

Ultimately, the different criteria heretofore enunciated under Section 532(a) relate to the extent of the taxpayer's burden of proof. If taxpayer must prove that tax motives were not present or played no part in its decision to accumulate earnings, as a practical matter the subjective element has been eliminated from the statute and taxpayer is limited to definite and fixed commitments. Thus prejudiced is the taxpayer which in good faith desires, for example, to expand its business, either internally or through acquisition, in related or unrelated areas, but which has not formulated sufficiently definite plans or has not, when the revenue agent comes in on audit, proceeded to such an extent that credit is permitted under Section 535(c) (1).[46]

This situation is most common in closely held businesses which are considering an expansion or diversification plan and which cannot move precipitously in view of the fact that an erroneous business decision would place the en-

[45] *See* Petitioner's Brief for Certiorari at 8.

[46] *See generally Bremerton Sun Publ. Co., supra* n. 29.

tire business in financial jeopardy. In the usual situation, the closely held corporation is unlikely to proceed until it has achieved a strong and sound financial condition permitting it to survive reverses occasioned by its decision to expand or diversify. Further, because of its inexperience in the field of expansion and diversification, the closely held corporation tends to be more cautious, and accordingly, takes longer to effect an expansion program or consummate an acquisition. The net effect of the government's position would require the taxpayer to enter into expansion or acquisition plans prematurely and subject itself to the attendant risks, or face the Hobson's choice of paying the Section 531 tax or paying dividends.

Petitioner complains that the Sixth Circuit's standard would tend to result in self-serving declarations unsupported by objective evidence or supported only by "carefully assembled" documentation. See Brief for Petitioner at 22. However, this is not an infirmity of the legal standard but is a question of the sufficiency of the evidence. When earnings exceed definite and certain business needs, the trier of fact would be justifiably cynical and suspicious of unsupported allegations of non-tax motives. To prove the negative, taxpayer would be called upon to establish a solid and substantial reason; in fact, the dominant, controlling or impelling motive for the failure to distribute "excess" earnings to its shareholders.

Finally, it must be recognized that the surtax penalty is applicable on a year-to-year basis. Accordingly, a taxpayer claiming that the principal, dominant or controlling reason for an accumulation is not for the avoidance of tax to its shareholders must be prepared to live with the reasons advanced in future years and the assumptions or reasons given must stand the test of credibility when compared with events materializing in future years. To the extent that a taxpayer's reasons are not substantiated by such events, its credibility is impaired and motives impuned. Accordingly, the "subjective test" provides little comfort to

the taxpayer unless its reasons for the accumulation are completely candid, reasonable in their context, and consistent with future conduct.

Petitioner's position herein is most difficult to comprehend. For not only is its argument inconsistent with this Court's decision in *Chicago Stock Yards Co., supra,* and the statutory scheme of the unreasonable accumulation provisions, but it is also at variance with its economic policies which favor competition and the promotion of the growth of smaller businesses. It should be absolutely clear that if the government's position is sustained in this case, the future growth and development of smaller businesses will be severely limited. We believe that such a result is neither provided for nor intended by the unreasonable accumulation provisions of the Internal Revenue Code.

CONCLUSION

The judgment of the United States Court of Appeals for the Sixth Circuit should be affirmed in all respects.

RICHARD L. BRAUNSTEIN
Attorney for Respondent

1225 Connecticut Avenue
Washington, D.C. 20036

BERNARD J. LONG
BERNARD J. LONG, JR.
RICHARD F. SWIFT
DOW, LOHNES AND ALBERTSON
Of Counsel

No. 17

IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

UNITED STATES OF AMERICA,
Petitioner,

v.

THE DONRUSS COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE SHAW-WALKER COMPANY AS *AMICUS CURIAE*

Richard E. Nolan
Attorney for The Shaw-Walker Company as Amicus Curiae
1 Chase Manhattan Plaza
New York, N. Y. 10005

John P. Carroll, Jr.
Jerome M. Congress
Davis Polk & Wardwell
Of Counsel

32 Case Press Inc., 421 Hudson St., N.Y.—ORegon 5-4540

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THE DONRUSS COMPANY

BRIEF FOR THE SHAW-WALKER COMPANY AS *AMICUS CURIAE*

Interest of The Shaw-Walker Company as *Amicus Curiae*

The issue in this case is the extent of the burden of proof a corporate taxpayer must carry to avoid the penalty of the accumulated earnings tax. This issue is before this Court not only in the *Donruss* case but also in *Commissioner of Internal Revenue* v. *The Shaw-Walker Company,* No. 95, October Term, 1968, in which the Government's Petition for Writ of Certiorari is now pending.

The Shaw-Walker Company has an immediate and vital interest in the resolution of this issue. In order to provide this Court with an opportunity to examine the issue in the light of the record in the *Shaw-Walker* case (which illuminates the practical consequences of the contentions of the parties in a way the record in *Donruss* does not), the Shaw-Walker Company moved on July 1, 1968 to consolidate the

two cases for argument. We understand this motion will be considered by the Court after the opening of the October Term. We also understand that the *Donruss* case has been scheduled for argument during the week of October 21, 1968. Being uncertain of the result of its motion for consolidation, and in order to present its views to the Court upon the issue here involved, Shaw-Walker respectfully submits this brief upon consent of the parties.

Statutes Involved

See Appendix to this Brief.

Question Presented

When tax avoidance is neither the "dominant", the "controlling", nor the "impelling" motive for a corporation's accumulation of all or a part of its earnings, may that corporation nevertheless be held to have been "availed of for the purpose of avoiding income tax with respect to its shareholders," under Sections 532 and 533 of the Internal Revenue Code of 1954, and therefore subject to the accumulated earnings tax?

Summary of Argument

The accumulated earnings tax is a penalty imposed wherever corporate earnings are accumulated to serve a manipulative scheme designed to avoid the income tax which would be imposed on shareholders if such earnings were distributed to them. The language of the statute, its legislative history and administrative interpretation, and, above all, the logic underlying its purpose and effect require the

conclusion that the tax may not be imposed unless tax avoidance is the "dominant", "controlling", or "impelling" motive for the accumulation, rather than the conclusion, urged by the Government, that the tax may be imposed even though tax avoidance is an incidental or subsidiary factor in the determination to retain a company's earnings. The "dominant purpose" test is supported by the decision of this Court in *Commissioner* v. *Duberstein,* 363 U.S. 278 (1960) and the better reasoned decisions of the courts of appeals.

The statutory presumption of tax avoidance purpose contained in Section 533(a) obviously gives the Government a significant advantage over the taxpayer in any accumulated earnings tax case. The issue in this case and the *Shaw-Walker* case is whether this presumption should be strengthened to such an extent as to give the Government a virtually conclusive advantage by forcing the taxpayer to prove, as the Government here demands, (Br., p. 18), a *total* absence of tax avoidance motive. Such a *per se* rule is contrary to the intent and purpose of the statute. The Government's claim that its proposed interpretation is required by administrative necessity is spurious.

ARGUMENT

A corporation is "availed of for the purpose of avoiding the income tax with respect to its shareholders" under the accumulated earnings tax provisions of the Internal Revenue Code only if tax avoidance was the "dominant, controlling, or impelling" motive for the corporation's retention of earnings.

A. Congress Intended the Accumulated Earnings Tax to be Imposed Only When a Corporation's Dividend Policy Is Dominated By a Manipulative Scheme to Avoid Income Tax on Its Shareholders

1. *Evolution of the statute*

Throughout their evolution, the statutory provisions imposing the accumulated earnings tax have been based on two fundamentally different factors: the accumulation of earnings beyond the needs of a corporate taxpayer's business, and the retention of earnings for the purpose of avoiding income taxes on the shareholders of a corporation. At its inception in 1913, the tax was assessed on shareholders of corporations "formed or fraudulently availed of for the purpose of preventing tax on the shareholders," and earnings accumulated beyond the needs of a corporation's business were "prima facie evidence of a purpose to escape such tax." Revenue Act of 1913, ch. 16, § (A)(2), 38 Stat. 114 (1913). In 1918 the word "fraudulently" was deleted, but only because the difficulty of proving common law fraud weighted the procedural balance too heavily in favor of the taxpayer. Ch. 18, § 220, 40 Stat. 1057 (1919), S. Rep. No. 617, 65th Cong., 3d Sess. 5 (1918).

Having previously shifted the tax from shareholders to their corporations, Congress in 1939 strengthened the presumption that accumulations beyond needs reflected the purpose of avoiding income taxes on the shareholders by making such accumulations "determinative of the purpose to avoid surtax upon shareholders unless the corporation by

the clear preponderance of the evidence shall prove to the contrary." Internal Revenue Code of 1939, § 102, 53 Stat. 35. When the statute became section 533(a) of the Internal Revenue Code of 1954, the word "clear" was omitted from the phrase describing the taxpayer's burden of overcoming the presumption.

The statute in both its earlier form and its present form has been construed as intended to impose the tax only when conventional corporate purposes are subordinated to tax avoidance purposes. The tax as it stood in 1921 was described thus:

> "No corporation which is actively engaged in business is to be subjected to the penalty of the statute unless and until it permits its course of conduct to be diverted from its normal business interests by a purpose to save its stockholders from surtax." *United Business Corp.* v. *Commissioner,* 19 B.T.A. 809, 828 (1930), *aff'd,* 62 F.2d 754 (2d Cir.), *cert. denied,* 290 U.S. 635 (1933).

In its opinion affirming the Board, the Second Circuit characterized the tax similarly, describing it as a tax aimed at "the manipulation of dividends." 62 F.2d at 756. Similarly, in *Electric Regulator Corp.* v. *Commissioner,* 336 F.2d 339, 346 (2d Cir. 1964), the court described the tax as it stood in 1957 as designed "to discourage . . . abusing the corporate form for the purpose of decreasing . . . personal tax liability, . . ."

Nothing in its evolution suggests that the statute in its present form is different from the 1913 statute in fundamental concept. Everything about its evolution suggests that the statute (which, after all, imposes the tax on a corporation availed of for "the" purpose of tax avoidance)

is aimed only at conduct which is warped out of its normal and legitimate course to serve the dominant antisocial purpose of manipulating corporate dividend policy to avoid personal income tax.

2. Tax avoidance purpose and a corporate accumulation of earnings in excess of its needs are separate in concept and function.

Both the courts and the Treasury's own regulations have consistently recognized that the two fundamental factors involved in the tax—accumulations beyond business needs and the purpose to avoid the tax on shareholders—are separate, and that either may be present when the other is entirely absent. Thus the courts have held that a corporation has not been availed of for the purpose of tax avoidance despite accumulation of its earnings beyond what were found to be the needs of the business. *E.g., United States* v. *Duke Laboratories, Inc.*, 337 F.2d 280 (2d Cir. 1964); *T. C. Heyward & Co.* v. *United States,* 66-2 U.S.T.C. ¶ 9667 (W.D.N.C. 1966); *Bremerton Sun Publishing Co.* v. *Commissioner,* 44 T.C. 566 (1965). Correspondingly, the Treasury Regulations provided that a corporation would be subject to the tax if used for the purpose of tax avoidance even if accumulations were reasonable. Treas. Reg. 103, § 19.102-2 (1940) (regulations under Section 102 of the Internal Revenue Code of 1939).*

* The rule is no longer applicable since section 535(c) of the Internal Revenue Code of 1954 reduces the quantum potentially subject to tax by any portion of a taxpayer's earnings reasonably accumulated for the needs of its business. However this change in result did not reflect any change in the fundamental structure of the statute. The quantum of earnings potentially subject to the tax was, in the 1939 Code and before, reduced by various items (*e.g.*, § 102 (d) (1) Internal Revenue Code of 1939) and the 1954 Code simply provided a similar and additional reduction for earnings retained for business needs.

In dealing with the accumulated earnings tax the courts have repeatedly stressed not only that the existence of unreasonable accumulations and of the purpose to avoid the tax on shareholders are separate questions, but also that the ultimate question is the purpose for which the corporation was used. *E.g., United Business Corp.* v. *Commissioner*, 62 F.2d 754, 755 (2d Cir. 1933). (L. Hand, J.); *Bremerton Sun Publishing Co.* v. *Commissioner*, 44 T.C. 566 (1965); *James M. Pierce Corp.* v. *Commissioner*, 38 T.C. 643 (1962), *acq.*, 1963-2 Cum. Bull. 5; *rev'd on other issue*, 326 F.2d 67 (8th Cir. 1964); *Pelton Steel Casting Co.* v. *Commissioner*, 28 T.C. 153 (1957), *aff'd*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958).

3. *The logic of the statute requires the "dominant purpose" test.*

As a penalty provision to deter the use of corporations as a device for avoiding taxes, the logic of the statute requires that the tax be assessed only where the purpose of avoiding shareholder taxes has a dominant force. Every human action has the "purpose" of bringing about any consequence which inevitably flows from it. *See, e.g., People* v. *Jernatowski*, 238 N.Y. 188 (1924); *People* v. *Nichols*, 230 N.Y. 221 (1921); *see also Osborne* v. *Montgomery*, 203 Wis. 223, 234 N.W. 372 (1931); *In re Polemis*, [1921] 3 K.B. 560. Putting a prosperous business into corporate form or continuing a prosperous business in that form almost inevitably has a tax avoidance "purpose" to some degree since the owners of prosperous businesses are usually people whose income taxes would be increased if they received the earnings of the business directly. However, the statute clearly does not strike at such actions so long as the legiti-

mate business purposes* to be served by them are dominant and the avoidance of shareholder taxes necessarily following from them is incidental. Rather, application of the tax must depend on subordination of legitimate corporate activities to the goal of tax avoidance.

The conclusion that the logic of the statute requires assessment of the tax only when tax avoidance is the "dominant, controlling, or impelling" purpose of accumulations has been reached by the Sixth Circuit below (and subsequently in *Shaw-Walker Company* v. *Commissioner,* 390 F.2d 205 (6th Cir. 1968); *petition for certiorari pending No. 95 this Term*) and by the First Circuit in *Young Motor Co.* v. *Commissioner,* 281 F.2d 488, 491 (1st Cir. 1960). The First Circuit recognized that the simplistic rule the Government now seeks would result in virtually every solvent corporation being chargeable with the proscribed purpose:

> "The Tax Court may have been led into this error by a misconception of the precise issue. In its opinion it referred to preventing the imposition of the surtax upon stockholders as 'one' of taxpayer's purposes, and stated, 'If this purpose exists it may be accompanied by other legitimate business objectives and still the statute will apply.' The court discussed at some length that taxpayer, being controlled by Young, must be taken to have known that declaring dividends would increase Young's surtaxes—a proposition scarcely requiring argument. If knowledge of such a result is to be the test of purpose, then the only corporations that could safely accumulate in-

* *E.g.,* insulation of owners against tort liability; centralizing management for efficiency; preventing minor or incompetent members of a family from meddling in management; facilitating administration of the estates of owners; facilitating gifts or sales of interests in the business; facilitating borrowing by the business.

come would be those having stockholders with substantial net losses. The statute does not say 'a' purpose, but 'the' purpose. The issue is not what are the necessary, and to that extent contemplated consequences of the accumulation, but what was the primary or dominant purpose which led to the decision. *Cf.* Commission of Internal Revenue v. Duberstein, 1960, 363 U.S. 278, 80 S. Ct. 1190, 4 L.Ed.2d 1218."

Both the First and Sixth Circuits saw parallels in cases in which this Court has held that determination of the "purpose" underlying an act requires detailed examination of all the facets of that act, requires striking a balance between the conflicting inferences to be drawn from them and then requires categorizing the act in terms of that balance. In *Commissioner* v. *Duberstein,* 363 U.S. 278 (1960), this Court rejected the Commissioner's argument that the question whether a transfer between persons having a business relationship was a gift or a payment for services should be decided by presuming that such transfers could not reflect the type of intent requisite to a gift. The Court refused to limit investigation into the intent behind transfers of property in this arbitrary manner, holding that

> "... the proper criterion, established by decision here, is one that inquires what the basic reasons for his [the taxpayer's] conduct was in fact—the dominant reason that explains his action in making the transfer." 363 U.S. at 286.

Recognizing the wide variety of motives which might affect any disposition of one's property, this Court held that findings of fact as to an individual's purpose must be based not on any mechanical rule, but

> ". . . ultimately on the application of the fact-finding tribunal's experience with the mainsprings of

human conduct to the totality of the facts of each case." 363 U.S. at 289.

The decision in *Duberstein* was a restatement of doctrine this Court had enunciated earlier in cases holding that transfers of property are made "in contemplation of death" within the meaning of the estate tax statutes only if the dominant, controlling, or impelling motive for the transfer was awareness of approaching death. *Allen* v. *Trust Company of Georgia,* 326 U.S. 630, 636 (1946); *City Bank Farmers Trust Co.* v. *McGowan,* 323 U.S. 594, 599 (1945); *United States* v. *Wells,* 283 U.S. 102, 118 (1931).*

The Sixth Circuit in this case referred to these decisions and applied the same criteria in construing the accumulated earnings tax:

> "In our view there is no sound reason why the 'dominant, controlling, or impelling' motive test employed in connection with the gift in contemplation of death provision should not be applied to the accumulated earnings tax provision. Both provisions have as their underlying purpose the prevention of tax avoidance which is made possible by the structure of the income tax laws. Neither provision explicitly sets out the extent to which the proscribed purpose must play a part in the transaction

* The Government argues that differences between the accumulated earnings tax and the gift and estate taxes make analogies between them inappropriate, stating: "In Duberstein, this Court was unwilling to draw on precedents based on other provisions of the tax code" (Br., p. 5). However, in the passage in *Duberstein* to which the Government refers to support this assertion, this Court was not considering whether the method of inquiring into "purpose" where that is decisive under one portion of the Code should be employed where "purpose" is decisive under another. It only said there was little value in looking to gift tax and estate tax provisions of the Code for enlightenment on the "meaning of the term 'gift' as applied to particular transfers" for purposes of the income tax. 363 U.S. at 284.

> or conduct in order for the tax consequences to attach. To hold that the dominant, controlling, or impelling motive criterion is inapplicable in the case of the accumulated earnings tax provision would require that we make a distinction where no material difference exists."

Indeed, application of the rule that "the purpose" of a taxpayer's use of property must be the dominating or impelling purpose (rather than a subsidiary motive or incidental result) is more appropriate in the accumulated earnings tax area than in the gift and estate tax areas, because the accumulated earnings tax is a "penalty" on "improper" utilization of corporations for the purpose of tax avoidance. See *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 288-89, 290 (1938). As such it should not be imposed where tax considerations are incidental to legitimate business purposes.*

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* The Government's suggestion that *Spies* v. *United States*, 317 U.S. 492 (1943), provides an analogy supporting its position is completely unfounded. The question in that case was whether a taxpayer who "willfully failed to make a return of taxable income" (a misdemeanor under Section 145(a) of the Revenue Act of 1936) and "willfully failed to pay the tax due on his income for that year" (a second misdemeanor under the same statute) could be held guilty of the third crime (a felony under Section 145(b) of the Act) of willfully attempting "in *any* manner to evade or defeat" the same income tax if nothing more was shown. 317 U.S. at 493-94. (Emphasis added.) This Court reversed a decision that the taxpayer could be convicted on this basis. It held:

> "We think that in employing the terminology of attempt to embrace the gravest of offenses against the revenues, Congress intended some willful commission in addition to the willful omissions that make the list of misdemeanors." 317 U.S. at 499.

The whole point of the decision was that conviction of a felony depended on there being an act unequivocally directed to the particular purpose proscribed by Section 145(b), the purpose of evasion. The Court went on to note, in the words quoted by the Government (Br.,

4. *The Treasury's regulations presuppose the "dominant purpose" test.*

The Treasury's regulations have always implied that a corporation's dividend policy must be dominated by a scheme to reduce the income taxes of shareholders if the tax is to be imposed. The regulations under the 1954 Code provide that:

(a) The presence or absence of "the purpose to avoid income tax with respect to the shareholders" can be evidenced by factors other than those indicating simply the existence of an accumulation of earnings beyond the needs of a taxpayer's business.*

(b) To determine whether the requisite tax avoidance purpose is present, "the particular circumstances of each case" must be examined.

(c) The following specific factors must be considered in this examination:

(i) any withdrawal of funds from the corporation as loans to shareholders;

(ii) any expenditure of funds by the corporation for the personal benefit of shareholders;

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p. 15), that once a course of action unequivocally directed to the purpose proscribed by the statute had been shown, it was irrelevant whether it also had another legal significance. If a valid analogy could be drawn from *Spies* (which seems dubious), it would appear to point to the conclusions (i) that a corporation could be held subject to the tax only if it took a course of affirmative action unequivocally directed to avoiding tax on its shareholders and (ii) that such a course of action would cause the tax to be imposed even though it had a dual legal significance, such as avoiding state income tax on the same shareholders.

* "The existence or nonexistence of the purpose to avoid income tax with respect to shareholders may be indicated by circumstances other than the conditions specified in section 533." Treas. Reg. § 1.533-1(a)(2)(1959).

(iii) any investment of funds by the corporation in assets unconnected with its business, and

(iv) the extent to which the corporation has distributed its earnings.

(d) All the specific factors to be examined in a particular case cannot be enumerated in advance, and those listed in the regulations are only those to be examined "among other things." Treas. Reg. § 1.533-1(a)(2) (1959).

The regulations under statutes prior to the 1954 Code were of the same tenor.* The regulations under the Internal Revenue Code of 1939 are substantially the same as those under the 1954 Code.

The whole thrust of the regulations is fundamentally inconsistent with the Government's argument here. Going backwards in time, fewer and fewer of the phrases now present in the regulations can be discerned. For example, compare Article 542, Regulation 77 (1933) with Article 102-2, Regulation 86 (1935). As it has elaborated its regula-

* Regulations 118, § 39.102-2 (1953); Regulations 111, § 29.102-2 (1943); Regulations 103, § 19.102-2 (1940) (all under the Internal Revenue Code of 1939, § 102);
Regulations 101, Art. 102-2 (1939) (Revenue Act of 1938, § 102);
Regulations 94, Art. 102-2 (1936) (Revenue Act of 1936, § 102);
Regulations 86, Art. 102-2 (1935) (Revenue Act of 1934, § 102);
Regulations 77, Art. 542 (1933) (Revenue Act of 1932, § 104);
Regulations 74, Art. 542 (1929) (Revenue Act of 1928, § 104);
Regulations 69, Art. 352 (1926) (Revenue Act of 1926, § 220);
Regulations 65, Art. 352 (1924) (Revenue Act of 1924, § 220);
Regulations 62, Art. 352 (1922) (Revenue Act of 1921, § 220);
Regulations 45 (1920 Edition), Art. 352 (1921) (Revenue Act of 1918, § 220);
Regulations 45, Art. 352 (1919) (Revenue Act of 1918, § 220);
Regulations 33 (Revised), Art. 19 (1918) (Revenue Act of 1917, § 2).

tions over the decades, the Treasury has indicated with increasing clarity an awareness that the tax avoidance purpose proscribed by the statute is a manipulative purpose which dominates corporate dividend policy.

Regulations embodying the Government's approach would state that a single inference of a tax avoidance purpose drawn from examining *any* aspect of a corporation's activities would establish the tax avoidance purpose at which the statute is directed. However, the regulations do not so provide. Rather, by requiring the examination of *all aspects* of company policy, the regulations indicate that a finding as to the existence or absence of the proscribed purpose requires balancing all the inferences to be drawn from all the facets of corporate activity and of corporation-shareholder relationships to determine whether or not the purpose of avoiding taxes was predominant. If, as the Government argues, a corporation should be considered to have been availed of for the purpose of tax avoidance in the sense of the statute whenever tax avoidance can be inferred from *any* facet of its policy, the admonition of the regulations to examine *all* facets of its policy is meaningless.

5. The cases cited by the Government do not support its construction of the statute.

The Government asserts repeatedly that, in *Helvering v. Chicago Stock Yards Co.*, 318 U.S. 693 (1943), this Court construed the statutory predecessor of the present Code provisions as imposing the accumulated earnings tax on any corporation if its management entertained any purpose of tax avoidance whatever, even though that purpose was not a decisive factor in the operation of the company.

(Br., pp. 6, 7, 10, 11, 15, 19, 21, 25) But this Court did not conceive the *Stock Yards* case as presenting any such question, and the Government completely misconstrues the portion of the *Stock Yards* opinion it so frequently quotes.

The Board found the Stock Yards company to be "Prince [its sole shareholder] in corporate clothes." 41 B.T.A. 590, 621. The Board explicitly held that the sole purpose of the company's retention of earnings, indeed the sole purpose of its existence, was tax avoidance:

> "It was of no moment to Prince whether the earnings of the petitioner were carried in his individual pocketbook or in his corporate pocketbook, except that if they had been received in the first instance in his individual pocketbook or distributed to him by the petitioner he would have been subjected to heavy surtaxes upon them, while he avoided such surtaxes by retaining them in the corporation." *Ibid.*

The Court of Appeals reversed the Board's decision imposing tax and remanded for further consideration. *Chicago Stock Yards Co.* v. *Commissioner*, 129 F.2d 937 (1st Cir. 1942). This Court reversed the Court of Appeals and reinstated the decision of the Board. This Court's opinion makes three points, none of which support the Government's strained construction of the statute.

The first point disposed of the contention that, since the company's accumulation plan originally had no tax significance, its continuance could not properly be characterized as a tax avoidance device within the meaning of the statute. This point was couched in the words much quoted in the

Government's brief in the case at bar,* but the words were not directed to the question posed here, which had not been raised by the parties in the Supreme Court. In the quoted passage the Court said only that a plan begun in pre-tax years and extended into taxable years could justifiably be treated by the Board as being a tax avoidance scheme within the meaning of the statute during the later years. This Court did not consider whether a recognition of tax avoidance in corporate planning could be the basis for imposing the earnings tax when tax avoidance was not a dominant factor in that planning.

The second and central point in the *Stock Yards* opinion was that the Board was justified in its conclusion that the sole purpose of the plan during the later years was tax avoidance. This portion of the opinion summarizes the accumulation plan and its effects and holds that "although Mr. Prince denied any purpose to avoid surtaxes, the Board . . . was free to conclude, upon all the evidence, that such was the purpose." 318 U.S. at 701.

This Court's final point was that the Board's conclusion was not subject to judicial review because:

> "We cannot say that the Board's conclusion that respondent was availed of for the purpose of preventing the imposition of surtax upon its stockholders . . . is without substantial support." 318 U.S. at 702.

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* "A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulations was adopted, the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice." 318 U.S. at 699.

This ultimate holding reflects the fact that, between 1926 and 1948, the powers of courts of appeals to review decisions of the Board of Tax Appeals and the Tax Court were sharply limited by statute.* As a result of this limitation on appellate review, this Court held in *Dobson v. Commissioner,* 320 U.S. 489, 501-02 (1943), that when an appellate "court cannot separate the elements of a [Tax Court] decision so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand."

The Board found that tax avoidance was the sole purpose of the taxpayer in *Stock Yards,* and there could be no doubt the tax was properly imposed under any rule of law after this finding. This Court had no occasion in *Stock Yards* to consider what was the proper construction of the "purpose" clause in the accumulated earnings tax provisions, and did not do so. It examined the two conclusions the Board actually reached; first, the conclusion that a pre-tax plan continued during a taxable period could be a tax avoidance device, and, second, the conclusion that the Stock Yards company was nothing but a tax avoidance device. This Court did not purport to hold that the decision

* The Revenue Act of 1926, in § 1003(a), vested exclusive jurisdiction to review decisions of the Board of Tax Appeals in the courts of appeals, and restricted any review of issues of fact, providing:

> "Upon such review, such courts shall have power to affirm or, *if the decision of the Board is not in accordance with law,* to modify or to reverse the decision of the Board . . ." § 1003(b), 44 Stat. 110. (Emphasis added.)

The 1939 Internal Revenue Code in §§ 1141(a), (c) adopted the same provisions. 53 Stat. 164 (1939). Section 36 of the Act of June 25, 1948, again vested exclusive appellate jurisdiction of Tax Court decisions in the courts of appeals but provided that such review should be coterminous with the scope of review in federal civil nonjury actions. Act of June 25, 1948, Ch. 646, § 36, 62 Stat. 991. The 1948 amendment is now Section 7482 of the Internal Revenue Code of 1954.

of the Board was correct because the tax it imposed could have been properly imposed even if the Board had reached some different conclusion (for example, a conclusion that reducing Prince's tax was contemplated by the directors of Stock Yards but was not of decisive force). The *Stock Yards* case is irrelevant to the question presented here and does not support the Government's position.

The Government also relies on *Trico Products Corp.* v. *Commissioner*, 137 F.2d 424, 426 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943) for its view that the Second Circuit has rejected the "dominant purpose" test. That decision, however, was premised on an interpretation of the *Stock Yards* case as a holding that the "dominant purpose" test was not correct, an interpretation which, for the reasons given above, we submit is erroneous.

The Government repeatedly refers to *Barrow Mfg. Co.* v. *Commissioner*, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962), as adopting the "any purpose" test (Br., pp. 19, 23-24, 26). It is submitted that the rationale of this decision is obviously erroneous and that it should be overruled. It rests on the premise that, if the tax may be imposed only when a corporation's dividend policy is dominated by a scheme to avoid taxes, the Section 533(a) presumption created by a determination that earnings have been accumulated beyond needs "is well nigh destroyed if that presumption in turn is saddled with requirements of proof of 'the primary or dominant purpose' of the accumulation." 294 F.2d at 82. This turns the statute completely around. The presumption functions after it is determined that earnings have been retained beyond needs. At that point it is the taxpayer who must prove a negative—the

lack of a dominant intent to avoid taxes—not the Government, in whose favor the presumption runs.

Finally, the Government incorrectly ascribes to the Eighth and Tenth Circuits agreement with its position. These courts in *World Publishing Co.* v. *United States*, 169 F.2d 186, 189 (10th Cir. 1948), *cert. denied,* 335 U.S. 911 (1949), and *Kerr-Cochran, Inc.* v. *Commissioner,* 253 F.2d 121, 123 (8th Cir. 1958) held that the tax may be imposed when tax avoidance was "one of the determinating" motives of an accumulation. Although the Eighth and Tenth Circuits did not discuss the degree of importance a purpose must have to be a "determinating" purpose, the Tenth Circuit's view was that:

> "In all such cases as this, no single factor can be pointed to as controlling. A correct answer can be reached [on the question of whether there was a determinating purpose to avoid tax] only in considering all of the facts and circumstances of the particular business under consideration and of the owner or owners of such business." 169 F.2d at 189.

Contrary to the Government's contention, these cases do not support its position, but rather suggest, as we urge, that a balancing of the taxpayer's various motives for accumulating earnings is required before one can decide whether tax avoidance was a "determinating" motive. At minimum, it seems clear that a purpose which is "determinating" in the sense of the opinions of the Eighth and Tenth Circuits must be one which contributes substantially to the decision to retain earnings, while the Government contends here that any inference of a tax avoidance motive, no matter how slight, provides a basis for the tax.

B. The Government's Interpretation Would Incorrectly and Unrealistically Impose a *Per Se* Rule, Inconsistent With Section 533(a), That the Tax Be Imposed Whenever It Is Determined That a Corporation Has Accumulated Earnings Beyond the Needs of Its Business.

The Government argues that the accumulated earnings tax must be applied "unless there is a *complete absence* of tax avoidance motive for an unreasonable accumulation" (Br., p. 18; emphasis added), and that the tax must be imposed ". . . except in those unusual cases where the trier of facts is persuaded that tax avoidance played *no part* in inducing the unnecessary accumulation." (Br., p. 21; emphasis added.) This interpretation is not only wrong in view of the plain meaning of Sections 531 through 533(a), their legislative history, and their administrative interpretation, but because it would require a taxpayer to carry a burden of proof which it could never, in practice, carry—the burden of proving that considerations of tax consequences to shareholders were entirely absent from the minds of the corporate managers whose decisions led to the accumulation of earnings.

It is a commonplace that the actual or possible effects of federal income taxes are routinely recognized by managers framing corporate policy.* In family corporations or other closely held companies it is impossible to imagine that, in deliberations about distributing dividends, there could humanly be the "complete absence of tax avoidance

* See *Young Motor Co.* v. *Commissioner*, 281 F.2d 488, 491 (1st Cir. 1960), *supra* pp. 8-9, and the observation of Judge Learned Hand in *Commissioner* v. *National Carbide Corp.*, 167 F.2d 304, 306 (2d Cir. 1948), *aff'd*, 336 U.S. 422 (1949), that "in a society like our own . . . business is always shaped to the form best suited to keep down taxes"; see also *Commissioner* v. *Tower*, 327 U.S. 280, 288-89 (1946); *A. E. Green Export Co.* v. *United States*, 284 F.2d 383, 389-90 (Ct. Cl. 1960).

motive" of the sort the Government demands. This is particularly obvious when it is recognized that the Government would couple its construction of Section 533(a) to the assertion that a corporate management's recognition of the tax consequences to its shareholders which would follow from distributing a dividend implies a tax avoidance purpose. By doing this, the Government would convert a rebuttable presumption into a *per se* rule which would almost inevitably charge any family owned or other closely held corporation with the tax avoidance purpose proscribed by the statute.*

A definition of purpose which gives the taxpayer a meaningful opportunity to rebut the presumption is particularly important under the accumulated earnings tax provisions of the Code. A finding of unreasonable accumulation, while clearly of evidentiary weight on the question of purpose, is not logically inconsistent with an absence of intent by a corporation to avoid taxes on its shareholders. The accumulation may, of course, reflect the proscribed purpose,

* The Government argued, for example, in *Shaw-Walker* and *Young Motor* that, if the controlling shareholders of a corporation would have had to pay additional income tax as a result of an increase in its dividends, the inference that earnings were accumulated for the proscribed purpose must be drawn. The Tax Court expressly found in *Shaw-Walker* that none of the factors specified in the Treasury Regulations as indicative of the purpose of tax avoidance were present. *Shaw-Walker Company* v. *Commissioner*, 390 F.2d 205, 215-16 (6th Cir. 1968). The record in *Shaw-Walker* includes substantial additional, and undisputed, evidence that the company was not managed for tax avoidance purposes. (See the references to the record in Shaw-Walker's Response to the Petition for Writ of Certiorari, No. 95, October Term, 1968 at pp. 3 and 6.) The Government's decision to petition for certiorari in *Shaw-Walker* on the record in that case demonstrates that it views its "any purpose" test as having the practical effect of imposing the tax whenever accumulations of earnings are held to exceed the reasonable needs of a corporation the shareholders of which are subject to substantial federal income tax.

but it may also simply reflect a mistake in judgment on the part of management or a difference in judgment between management and the fact finder on the question of the reasonable needs of the corporation. See *Electric Regulator Corp.* v. *Commissioner,* 336 F.2d 339, 346-47 (2d Cir. 1964).

Under the Government's strained interpretation, the slightest evidence that corporate executives considered the possible tax consequences of a dividend upon the shareholders would be fatal to any claim by the taxpayer that an accumulation was made in good faith, though there is substantial objective evidence of this. The Government's interpretation would render meaningless the taxpayer's right under Section 533(a) to disprove the statutory presumption that the accumulation was improper and would effectively delete from Section 533(a) the "unless" clause which gives a taxpayer the right to rebut the presumption. Certainly there is no evidence in the legislative history of the accumulated earnings tax that Congress, in enacting Section 533(a) and its predecessors, intended a taxpayer's right to rebut this presumption to be illusory. The accumulated earnings tax is, as the courts have held and the Government concedes (Br., p. 15, footnote), a penalty tax rather than a usual income tax. It is submitted that in a situation such as this involving a penalty, legislative intent to deprive a taxpayer of the right of rebuttal should not easily be inferred. The Government's position should be rejected as unfair and impractical.

C. The Government's Claim that It Requires the "Any Purpose" Test to Enable It to Enforce the Revenue Laws Properly is Spurious

The Government's alleged justification for the unrealistic rule which it proposes is that:

> ". . . such questions of intent are not satisfactorily tried on the basis of the self-serving, after-the-fact, trial testimony of the corporate managers" (Br., p. 19);

and that

> "Assessment of the relative importance and priority of several motives is even more difficult. Generally no evidence would be available other than the trial testimony of corporate managers that in their minds any thought of tax avoidance was no more important than (or was subordinated to) other objectives. There will rarely be objective evidence by which such claims may be tested" (Br., p. 22);

and that

> "The taxpayer may rest on unchallengeable and entirely unprovable assertions of state of mind, and no longer need 'disclose the facts' (62 F.2d at 756) that corroborate his assertions." (Br., p. 23)

This claim of administrative inconvenience rests on an apparent misunderstanding of the statutory scheme (which contains a presumption strongly favoring the Government), a seeming lack of awareness of the extensive fact-gathering machinery available to the Government, and a total lack of sympathy for the principle, basic to our system of law, that courts and juries are competent to decide issues of fact. The argument ignores the fact that issues of motive, intent and purpose are routinely tried in criminal pro-

ceedings and in a variety of civil actions, such as fraud cases, in courts in every state. It is fair, we submit, to assume that many of these cases involve situations as complex as those which may be found in accumulated earnings tax cases. Yet courts and juries do decide such issues without the need to constrict, as the Government suggests here, established defenses and rules of evidence to the point of practical uselessness.

Throughout the Government's brief, it is implied that the question of the presence or absence of a "dominant purpose" of tax avoidance must necessarily be determined on *viva voce* testimony consisting of the corporate management's assertions about its several and collective states of mind. This entirely ignores the long-standing Treasury regulations which provide that the purpose issue under Sections 531 *et seq.* of the Code is to be tried under "principles applicable to income tax cases generally." Treas. Reg. § 1.533-1(b) (1959). These principles are conventional rules of evidence.* The Government's argument also ignores the fundamental rule that any subjective state is subject to proof by direct or circumstantial objective evidence.

What is true of the rules of proof with respect to any subjective state is equally true of the rules with respect to proving relative weight or priority where a variety of subjective motives are present or assertedly present. The Treasury's own regulations (pp. 12-13, *supra*) provide that objective evidence of financial transactions in various categories are all to be examined for the inferences which

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* Proceedings in the Tax Court are to be tried under the rules of evidence applicable in trials without a jury in the District Court for the District of Columbia. Internal Revenue Code of 1954, § 7453. Actions for refund are, of course, tried under the Federal Rules of Civil Procedure applicable to all federal civil litigation.

can be drawn from them respecting the presence or absence of the proscribed purpose. These regulations demonstrate the groundlessness of the fears voiced by the Government concerning the nature of the proof which will be offered and the difficulties of assessing this proof if the taxpayer's construction of the statute is accepted.

The Government's further assertion that the taxpayer need not disclose the facts and can rest on glib, self-serving statements by corporate managers is equally unfounded. Central to the statutory scheme is the fact that the Government receives the benefit of the presumption created by Section 533(a) and that it is the taxpayer, not the Government, which is saddled with the burden of rebutting that presumption and of coming forward with evidence to disprove the presence of the proscribed purpose. This statutory burden is a heavy one to meet; it should not be increased, as the Government urges, to the point where it makes the taxpayer's rights illusory and prevents the taxpayer from ever, in practice, proving that it was not functioning to serve a scheme of manipulation.

In addition to the advantage conferred upon it by the statutory presumption, the Government has the benefit of extremely broad powers of discovery into the facts. In addition to discovery and subpoena powers accorded under the Federal Rules of Civil Procedure which are available in refund suits, Sections 7602 through 7608 of the Internal Revenue Code of 1954 grant unusually broad authority for the examination of books, records and witnesses by the Internal Revenue Service. The breadth and strength of the Government's powers to gather facts under these provisions have been emphasized in recent decisions such as those in *United States* v. *Powell,* 379 U.S. 48 (1964), *United States*

v. *McKay*, 372 F.2d 174 (5th Cir. 1967), and *DeMasters* v. *Arend*, 313 F.2d 79 (10th Cir.), *cert. denied*, 375 U.S. 936 (1963).

In view of these powers, the Government's claim that it will be unable to meet "self-serving" testimony of corporate managers who need not "disclose the facts" is without substance. Long prior to the trial of an accumulated earnings tax case, the Government has available for its examination every scrap of documentary proof and is free to examine all necessary witnesses. The evidence it develops is available not only for purposes of impeachment, but also as substantive evidence of proscribed purpose to rebut evidence the taxpayer offers. The availability of such fact-gathering devices, coupled with the statutory presumption favoring the Government under Section 533(a), clearly gives the Government a very considerable advantage in any accumulated earnings tax case. There is no rational basis for the argument advanced by the Government in this case that effective administration of the tax is impossible under the construction of Section 533(a) employed by the Sixth Circuit in the *Donruss* and *Shaw-Walker* cases.

CONCLUSION

It is respectfully urged that this Court affirm in all respects the judgment of the Court of Appeals.

Respectfully submitted,

Dated: New York, New York
August 10, 1968

RICHARD E. NOLAN
Attorney for The Shaw-Walker Company as Amicus Curiae

JOHN P. CARROLL, JR.
JEROME M. CONGRESS
DAVIS POLK & WARDWELL
Of Counsel

APPENDIX

Statutes Involved

Internal Revenue Code of 1954:

SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

[26 U.S.C. 531]

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) *General Rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

[26 U.S.C. 532(a)]

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

[26 U.S.C. 533(a)]

No. 17

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1968

UNITED STATES OF AMERICA, *Petitioner*

v.

THE DONRUSS COMPANY, *Respondent*

On Writ of Certiorari
to the United States Court of Appeals
for the Sixth Circuit

PETITION FOR REHEARING

RICHARD L. BRAUNSTEIN
Attorney for Respondent
1225 Connecticut Avenue
Washington, D. C. 20036

BERNARD J. LONG
BERNARD J. LONG, JR.,
RICHARD F. SWIFT

DOW, LOHNES AND ALBERTSON
Of Counsel

February, 1969

IN THE

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UNITED STATES OF AMERICA, *Petitioner*

v.

THE DONRUSS COMPANY, *Respondent*

On Writ of Certiorari
to the United States Court of Appeals
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PETITION FOR REHEARING

Respondent, The Donruss Company, hereby petitions this Honorable Court pursuant to Rule 58 for rehearing with respect to that part of the Opinion of the Court dated January 13, 1969 which limits the issue to be determined by the District Court upon remand to "whether avoidance of shareholder tax was one of the purposes of respondent's accumulations." (p. 5) In support of its petition, respondent states as follows:

GROUNDS FOR REHEARING

1. In presenting its case to the District Court upon the issue framed by the Court, respondent will necessarily introduce evidence concerning all of the business needs which it claims objectively justify its accumulations, because the existence or absence of such reasons and the substantiality

or credibility thereof will be relevant to the issue of respondent's purpose or purposes for accumulating its earnings. Accordingly, there will be no signficant economy in limiting jury consideration to the subjective issue alone.

2. Because the subjective and objective issues are so inextricably intertwined, a trial on the subjective issues alone would tend to confuse the jury. Moreover, if the District Court were to instruct the jury that as a matter of law respondent accumulated its earnings in excess of what was reasonably needed in its business and that consequently, one of the purposes for the accumulations is presumed to be avoidance of shareholder tax, respondent would be unduly prejudiced in the eyes of the jury in presenting its case on the issue of purpose. In this regard respondent notes by way of analogy that in civil actions where an issue of punitive damages, and thus intent, is involved, a court reversing on the damage issue would not order a new trial on that question alone. *See, e.g., Crowell Collier Publ. Co. v. Caldwell,* 170 F.2d 941 (5th Cir. 1948); *Walcher v. Loew's, Inc.,* 129 F. Supp. 815 (E.D. Mo. 1949). To do so would be highly prejudicial. Thus, the Court of Appeals herein apparently recognized the confusion and prejudice which would result from a trial on the intent issue alone and its remand was not so limited. Record at 60, 61.

3. Subsequent to the hearing of this case in the District Court (the jury verdict was returned on February 19, 1965, Record at 1), a number of significant cases have been decided which deal with the determination of reasonable business needs. For example, the Tax Court in *Bardahl Mfg. Co.*, 24 CCH Tax Ct. Mem. 1030 (1965) and the First Circuit in *Apollo Industries, Inc. v. Commissioner*, 358 F.2d 867 (1st Cir. 1966) enunciated new formulae for computing working capital needs, thus shedding some light upon an area which was theretofore confused and contradictory, *compare, e.g., Shaw-Walker Co. v. Commissioner*, 390 F.2d 205 (6th Cir. 1968), *vacated and remanded on other grounds,* ___ U.S. ___ (No. 95, Jan. 27, 1969) *and John P. Scripps*

Newspapers, 44 T.C. 453 (1965), *with F. E. Watkins Motor Co.*, 31 T.C. 288, 299 n.7 (1958), *acq.*, 1959-1 *Cum. Bull.* 5, *and J. L. Goodman Furniture Co.*, 11 T.C. 530, 535 (1958), *acq.*, 1949-1 *Cum. Bull.* 2. Similarly, in *Freedom Newspapers, Inc.*, 24 CCH T.C. Mem. 1327 (1965), the Tax Court has significantly liberalized the evidence required to justify earnings accumulations on the grounds of business expansion. *Accord, Faber Cement Block Co.*, 50 T.C. No. 17 (1968); *Shaw-Walker Co.*, 24 CCH Tax Ct. Mem. 1709 (1965), *rev'd on other grounds*, 390 F.2d 205 (6th Cir. 1968), *vacated and remanded*, ___ U.S. ___ (No. 95, Jan. 27, 1969). Respondent submits that to limit the hearing on remand solely to the issue of the subjective purposes for the earnings accumulation would be unduly prejudicial in that respondent would be denied the opportunity to develop a factual presentation on the issue of reasonable business needs in light of these recent decisions.

4. As previously stated, in reversing the judgment of the District Court and remanding for a new trial, the Court of Appeals did not limit the question to be determined thereupon to respondent's purposes for its earnings accumulation. Moreover, petitioner requested such a limitation neither before this Court, Brief for Petitioner at 27, nor before the Court of Appeals, Brief for Appellant at 19. Accordingly, the Court's restriction of the scope of the remanded proceedings comes without request therefor or the benefit of argument or discussion thereon, either here or in the Sixth Circuit.

CONCLUSION

Respondent respectfully requests this Court to issue its judgment and mandate directing that a complete *de novo* proceeding be held by the District Court.

RICHARD L. BRAUNSTEIN
Attorney for Respondent
1225 Connecticut Avenue
Washington, D. C. 20036

BERNARD J. LONG
BERNARD J. LONG, JR.
RICHARD F. SWIFT
DOW, LOHNES AND ALBERTSON
Of Counsel

CERTIFICATE OF COUNSEL

Pursuant to Rule 58 of the Rules of the Court, the undersigned hereby certifies that this Petition for Rehearing is presented in good faith and not for delay.

RICHARD L. BRAUNSTEIN

SUPREME COURT OF THE UNITED STATES

No. 17.—October Term, 1968.

United States, Petitioner, *v.* The Donruss Company.	On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

[January 13, 1969.]

Mr. Justice Marshall delivered the opinion of the Court.

This case involves the application of §§ 531–537 of the Internal Revenue Code of 1954, which impose a surtax on corporations "formed or availed of for the purpose of avoiding the income tax with respect to . . . [their] shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed."

Respondent is a corporation engaged in the manufacture and sale of bubble gum and candy and in the operation of a farm. Since 1954, all of respondent's outstanding stock has been owned by Don B. Wiener. In each of the tax years from 1955 to 1961, respondent operated profitably, increasing its undistributed earnings from $1,021,288.58 to $1,679,315.37. The company did not make loans to Wiener or provide him with benefits other than a salary, nor did it make investments unrelated to its business, but no dividends were declared during the entire period.

Wiener gave several reasons for respondent's accumulation policy; among them were capital and inventory requirements, increasing costs, and the risks inherent in the particular business and in the general economy. Wiener also expressed a general desire to expand and a

more specific desire to invest in respondent's major distributor, the Tom Huston Peanut Company. There were no definite plans during the tax years in question, but in 1964 respondent purchased 10,000 shares in Tom Huston at a cost of $380,000.

The Commissioner of Internal Revenue assessed accumulated earnings taxes against respondent for the years 1960 and 1961. Respondent paid the tax and brought this refund suit. At the conclusion of the trial, the Government specifically requested that the jury be instructed that:

> "[I]t is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings; it is sufficient if it is one of the purposes for the company's accumulation policy."

The instruction was refused and the court instructed the jury in the terms of the statute that tax avoidance had to be "the purpose" of the accumulations. The jury, in response to interrogatories, found that respondent had accumulated earnings beyond the reasonable needs of its business, but that it had not retained its earnings for the purpose of avoiding income tax on Wiener. Judgment was entered for respondent and the Government appealed.

The Court of Appeals reversed and remanded for a new trial, holding that "the jury might well have been led to believe that tax avoidance must be the sole purpose behind an accumulation in order to impose the accumulated earnings tax." *Donruss Co.* v. *United States*, 384 F. 2d 292, 298 (C. A. 6th Cir. 1967). The Court of Appeals rejected the Government's proposed instruction and held that the tax applied only if tax avoidance was the "dominant, controlling, or impelling motive" for the accumulation. *Ibid.* We granted the

Government's petition for certiorari to resolve a conflict among the circuits [1] over the degree of "purpose" necessary for the application of the accumulated earnings tax, and because of the importance of that question in the administration of the tax. 390 U. S. 1023 (1968).

I.

The accumulated earnings tax is established by §§ 531–537 of the Internal Revenue Code of 1954. Section 531 imposes the tax.[2] Section 532 defines the corporations to which the tax shall apply. That section provides:

> "The accumulated earnings tax imposed by section 531 shall apply to every corporation . . . formed or availed of for the purpose of avoiding the income

[1] The court below adopted the view of the First Circuit. See *Young Motor Co.* v. *Commissioner*, 281 F. 2d 488, 491 (1960); see also *Apollo Industries, Inc.* v. *Commissioner*, 358 F. 2d 867, 875–876 (1966). The Second Circuit has rejected "the view that the prevention of the imposition of surtaxes must have been shown to have been the dominant factor behind the accumulations." *Trico Prods. Corp.* v. *Commissioner*, 137 F. 2d 424, 426, cert. denied, 320 U. S. 799 (1943). See also *United States* v. *Duke Laboratories, Inc.*, 337 F. 2d 280 (1964). The Fifth Circuit has also rejected the position that tax avoidance must be the "primary or dominant" purpose of the accumulation. *Barrow Mfg. Co.* v. *Commissioner*, 294 F. 2d 79, 82 (1961), cert. denied, 369 U. S. 817 (1962). The Eighth and Tenth Circuits have taken what appears to be an intermediate position, holding that imposition of the tax is proper if tax avoidance is one of the "determinating purposes." *Kerr-Cochran, Inc.* v. *Commissioner*, 253 F. 2d 121, 123 (C. A. 8th Cir. 1958); *World Pub. Co.* v. *United States*, 169 F. 2d 186, 189 (C. A. 10th Cir. 1948), cert. denied, 335 U. S. 911 (1949). The Sixth Circuit has adhered to its view in *Shaw-Walker Co.* v. *Commissioner*, 390 F. 2d 205 (1968). A petition for certiorari in that case is now pending in this Court.

[2] The rates are 27½% of the accumulated taxable income (defined in § 535) not in excess of $100,000, plus 38½% of the accumulated taxable income in excess of $100,000. Internal Revenue Code of 1954, § 531.

tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided and distributed." [3]

Section 533 (a) provides that:

"For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."

In cases before the Tax Court, § 534 allows the taxpayer in certain instances to shift to the Commissioner the burden of proving accumulation beyond the reasonable needs of the business. Section 535 defines "accumulated taxable income." It also provides for a credit for that portion of the earnings and profits retained for the reasonable needs of the business, with a minimum lifetime credit of $100,000. Finally, § 537 provides that "reasonable needs of the business" include "reasonably anticipated" needs.

The dispute before us is a narrow one. The Government contends that in order to rebut the presumption contained in § 533 (a), the taxpayer must establish by the preponderance of the evidence that tax avoidance with respect to shareholders was not "one of the purposes" for the accumulation of earnings beyond the reasonable needs of the business. Respondent argues

[3] Section 532 (b) exempts personal holding companies, foreign personal holding companies, and certain tax-exempt corporations. Internal Revenue Code of 1954, § 532 (b). Both types of holding companies are taxed under other provisions of the Code. See Internal Revenue Code of 1954, §§ 541–547 (personal holding companies); Internal Revenue Code of 1954, §§ 551–558 (foreign personal holding companies).

that it may rebut that presumption by demonstrating that tax avoidance was not the "dominant, controlling, or impelling" reason for the accumulation. Neither party questions the trial court's instructions on the issue of whether the accumulation was beyond the reasonable needs of the business, and respondent does not challenge the jury's finding that its accumulation was indeed unreasonable. We intimate no opinion about the standards governing reasonableness of corporate accumulations.

We conclude from an examination of the language, the purpose, and the legislative history of the statute that the Government's construction is the correct one. Accordingly, we reverse the judgment of the court below and remand the case for a new trial on the issue of whether avoidance of shareholder tax was one of the purposes of respondent's accumulations.

II.

Both parties argue that the language of the statute supports their conclusion. Respondent argues that Congress could have used the article "a" in §§ 532 and 533 if it had intended to adopt the Government's test. Instead, argues respondent, Congress used the article "the" in the operative part of the statute, thus indicating that tax avoidance must at least be the dominant motive for the accumulation.[4] The Government argues that respondent's construction gives an unduly narrow effect to the word "the." Instead, contends the Government, this Court should focus on the entire phrase "availed of for the purpose." Any language of limitation should logically modify "availed of" rather than "purpose" and no such language is present. The Government further

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[4] The First Circuit in *Young Motor Co.* v. *Commissioner*, 281 F. 2d 488 (1960), in part based its conclusion that tax avoidance must be the "primary or dominant purpose" on the use of "the" rather than "a."

argues that Congress has dealt with similar problems in other sections of the Code and has used terms such as "principal purpose," §§ 269 (a), 357 (b)(1), and "used principally," § 355 (a)(1)(B). Similar terms could have been used in §§ 532 (a) and 533 (a), but were not. Finally, the Government points to the fact that prior to adoption of the Revenue Act of 1938, § 102, 52 Stat. 483, the forerunner of § 532 (a) used the words "the purpose," while the evidentiary section used the words "a purpose," thus indicating that tax avoidance need only be one purpose. Respondent replies that the change from "a" to "the" in the evidentiary section supports its conclusion. Respondent also contends that the statute before the change was consistent with its construction.

We find both parties' arguments inconclusive. The phrase "availed of for the purpose" is inherently vague, and there is no indication in the legislative history that Congress intended to attach any particular significance to the use of the article "the." Nor do we find the change in the evidentiary section from "a" to "the" at all helpful. That change came as part of a significant revision in the operation of the section, and there is no indication that it was other than a mere change in phraseology.[8] Indeed, the Report of the Senate Finance Committee accompanying the bill that was to become the Revenue Act of 1938, insofar as it sheds any light on the question, supports the view of the Government. "The proposal is to strengthen [the evidentiary] section by requiring the taxpayer by a clear preponderance of the evidence to prove the absence of *any* purpose to avoid surtaxes upon shareholders . . . ." S. Rep. No.

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[8] No change was made in that part of the statute providing that "the fact that any corporation was a mere holding or investment company shall be prima facie evidence of *a* purpose" to avoid tax. Revenue Act of 1938, § 102 (b), 52 Stat. 483 (emphasis added).

1567, 75th Cong., 3d Sess., at 5 (1938) (emphasis added). Since the language of the statute does not provide an answer to the question before us,[8] we have examined in detail the relevant legislative history. That history leads us to conclude that the test proposed by the Government is consistent with the intent of Congress and is necessary to effectuate the purpose of the accumulated earnings tax.

III.

The accumulated earnings tax is one congressional attempt to deter use of a corporate entity to avoid personal income taxes. The purpose of the tax "is to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable" for taxes on the dividends received, *Helvering* v. *Chicago Stock Yards Co.*, 318 U. S. 693, 699 (1943). The tax originated in the Tariff Act of 1913, 38 Stat. 114, the first personal income tax statute following ratification of the Sixteenth Amendment. That Act imposed a tax on the shareholders of any corporation "formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed . . . ." § II (A)(2), 38 Stat. 166. The same section provided that accumulation beyond the reasonable needs of the business "shall be prima facie evidence of a fraudulent purpose to escape such tax . . . ." 38 Stat. 167.

In its first years of operation, difficulties in proving a fraudulent purpose made the tax largely ineffective. To meet this problem, Congress deleted the word "fraudu-

[8] The Regulations shed no light on the problem. See Treas. Reg. §§ 1.531–1.537 (1959).

lently." Revenue Act of 1918, § 220, 40 Stat. 1072; see S. Rep. No. 617, 65th Cong., 3d Sess., at 5 (1918).[7]

During the next few years, numerous complaints were made about the ineffectiveness of the accumulated earnings tax. Various attempts were made to strengthen the tax during the 1920's and 1930's, but the statute remained essentially the same until 1934. See Joint Committee on the Economic Report, The Taxation of Corporate Surplus Accumulations, 82d Cong., 2d Sess., at 200–205 (1952). In 1934, Congress dealt with one of the more flagrant examples of that ineffectiveness, the personal holding company. Personal holding companies were exempted from the general accumulated earnings tax and were subjected to a tax on undistributed income, regardless of the purpose of that accumulation. Revenue Act of 1934, §§ 102, 351, 48 Stat. 702, 751. The reason for the change was that, "[b]y making partial distributions of profits and by showing some need for the accumulation of the remaining profits, the taxpayer makes it difficult to prove a purpose to avoid taxes." H. R. Rep. No. 704, 73d Cong., 2d Sess., at 11 (1934).

Again in 1936, Congress attempted to solve the continuing problem of undistributed corporate earnings. "The difficulty of proving such [tax avoidance] purpose . . . has rendered . . . [the accumulated earnings tax] more or less ineffective." H. R. Rep. No. 2475, 74th Cong., 2d Sess., at 5 (1936). However, Congress did not change the requirement that "purpose" must be proved. Rather, it attempted the alternative method of imposing an undistributed profits surtax on most corporations.

[7] Another major change was made in the Revenue Act of 1921, 42 Stat. 227. Section 220 of that Act shifted the incidence of the accumulated earnings tax from the shareholders to the corporation itself. 42 Stat. 247. The change was prompted by the decision in *Eisner* v. *Macomber*, 252 U. S. 189 (1920). See H. R. Rep. No. 350, 67th Cong., 1st Sess., at 12–13 (1921).

Revenue Act of 1936, § 14, 49 Stat. 1655. The tax on personal holding companies and the general accumulated earnings tax were retained.[8]

The problem continued to be acute and several proposals were made by and to Congress in 1938. The House Ways and Means Committee proposed a surtax on all closely held operating companies. Only minor changes were proposed by the Committee in the accumulated earnings tax. See H. R. Rep. No. 1860, 75th Cong., 3d Sess. (1938). The House rejected all but the changes in the accumulated earnings tax. The Senate approached the problem of retained corporate earnings in a different way. Labeling the House Committee's recommendation a "drastic" remedy, the Senate Finance Committee recommended "dealing with the problem where it should be dealt with—namely, in section 102, relating to corporations improperly accumulating surplus. The proposal is to strengthen this section by requiring the taxpayer by a clear preponderance of the evidence to prove the absence of any purpose to avoid surtaxes upon shareholders after it has been determined that the earnings and profits have been unreasonably accumulated." S. Rep. No. 1567, 75th Cong., 3d Sess., at 5 (1938). The change was thought to make it clear that the burden of proving intent, rather than the lesser burden of producing evidence on the question, was to be on the taxpayer. *Id.*, at 16. The Senate proposal was enacted. Revenue Act of 1938, § 102, 52 Stat. 483. The Committee felt that a "reasonable enforcement of this revised section will reduce tax avoidance . . . ." *Id.*, at 5.

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[8] Tax avoidance and evasion were a major subject of congressional concern in 1937. See, *e. g.*, H. R. Rep. No. 1546, 75th Cong., 1st Sess. (1937). Congress addressed itself to another aspect of the problem by establishing a separate method for the taxation of foreign personal holding companies, again without regard to corporate intent. Revenue Act of 1937, § 201, 50 Stat. 818.

Only insignificant changes were made in the accumulated earnings tax from 1938 to 1954. Discussion of the problem continued, however, and numerous proposals were made to alter the tax. See, *e. g.*, Joint Committee on the Economic Report, The Taxation of Corporate Surplus Accumulations, 82d Cong., 2d Sess. (1952). Congress took cognizance of these complaints and incorporated many of them in the Internal Revenue Code of 1954, but no change was made in the required degree of tax avoidance purpose.[9] Rather, the changes, which were generally favorable to the taxpayer,[10] demonstrated congressional disaffection with the effect of the tax and its emphasis on intent. Congress' reaction to the complaints was to emphasize the reasonable needs of the business as a proper purpose for corporate accumulations[11] and to make it easier for the taxpayer to prove those needs.[12] As the House Ways and Means Committee said, "Your committee believes it is necessary to retain the penalty tax on unreasonable accumulations as a safeguard against tax avoidance. However, several amendments have been adopted to minimize the threat

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[9] Congress was urged to adopt a test of purpose similar to that proposed by respondent in the present case. See, *e. g.*, Hearings before the House Committee on Ways and Means Pertaining to the General Revision of the Internal Revenue Code, 83d Cong., 1st Sess., pt. 3, at 2142 (1953).

[10] The changes were expected to decrease revenues by $10,000,000 in fiscal year 1955. See S. Rep. No. 1622, 83d Cong., 2d Sess., at 72 (1954).

[11] Section 535 (c) provided a credit for such accumulations.

[12] Section 534 allowed the taxpayer to shift to the Commissioner in certain instances the burden of proving unreasonable accumulation. Section 537 included anticipated needs as reasonable needs of the business. In addition to those changes, § 532 (a) omitted the requirement that the taxpayer negate the existence of tax avoidance purpose by a "clear preponderance of the evidence," and substituted a "preponderance" test.

to corporations accumulating funds for legitimate business purposes . . . ." H. R. Rep. No. 1337, 83d Cong., 2d Sess., at 52 (1954).

As this brief summary indicates, the legislative history of the accumulated earnings tax demonstrates a continuing concern with the use of the corporate form to avoid income tax on a corporation's shareholders. Numerous methods were employed to prevent this practice, all of which proved unsatisfactory in one way or another. Two conclusions can be drawn from Congress' efforts. First, Congress recognized the tremendous difficulty of ascertaining the purpose for corporate accumulations. Second, it saw that accumulation was often necessary for legitimate and reasonable business purposes. It appears clear to us that the congressional response to these facts has been to emphasize unreasonable accumulation as the most significant factor in the incidence of the tax. The reasonableness of an accumulation, while subject to honest difference of opinion, is a much more objective inquiry, and is susceptible of more effective scrutiny, than are the vagaries of corporate motive.

Respondent would have us adopt a test that requires that tax avoidance purpose need be dominant, impelling, or controlling. It seems to us that such a test would exacerbate the problems that Congress was trying to avoid. Rarely is there one motive, or even one dominant motive, for corporate decisions. Numerous factors contribute to the action ultimately decided upon. Respondent's test would allow taxpayers to escape the tax when it is proved that at least one other motive was equal to tax avoidance. We doubt that such a determination can be made with any accuracy, and it is certainly one which will depend almost exclusively on the interested testimony of corporate management. Respondent's test would thus go a long way toward destroying

the presumption that Congress created to meet this very problem. As Judge Learned Hand said of the much weaker presumption contained in the Revenue Act of 1921, 42 Stat. 247, "[a] statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed may be practically unenforceable without it . . . ." *United Business Corp.* v. *Commissioner*, 62 F. 2d 754, 755 (C. A. 2d Cir. 1933). And, "[t]he utility of . . . [that] presumption . . . is well nigh destroyed if . . . [it] is saddled with requirement of proof of 'the primary or dominant purpose' of the accumulation." *Barrow Mfg. Co.* v. *Commissioner*, 294 F. 2d 79, 82 (C. A. 5th Cir. 1961), cert. denied, 369 U. S. 817 (1962).

The cases cited by respondent do not convince us to the contrary. For the most part, they lack detailed analysis of the precise problem. Perhaps the leading case for respondent's position is *Young Motor Co.* v. *Commissioner*, 281 F. 2d 488 (C. A. 1st Cir. 1960). That case relied in part upon the use of the article "the" instead of "a." We have previously rejected that argument. The case also relied, as did the court below, on certain cases from the gift and estate tax areas.[15] We find those cases inapposite. They deal with areas of the Code whose language, purpose, and legislative history are entirely different from that of the accumulated earnings tax. See *Commissioner* v. *Duberstein*, 363 U. S. 278, 284 (1960).

Finally, we cannot subscribe to respondent's suggestion that our holding would make purpose totally irrelevant. It still serves to isolate those cases in which tax avoidance motives did not contribute to the decision to accumulate.

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[15] *Commissioner* v. *Duberstein*, 363 U. S. 278 (1960); *Allen* v. *Trust Co. of Georgia*, 326 U. S. 630 (1946); *City Bank Farmers Trust Co.* v. *McGowan*, 323 U. S. 594 (1945); *United States* v. *Wells*, 283 U. S. 102 (1931).

Obviously in such a case imposition of the tax would be futile. In addition, "purpose" means more than mere knowledge, undoubtedly present in nearly every case. It is still open for the taxpayer to show that even though knowledge of the tax consequences was present, that knowledge did not contribute to the decision to accumulate earnings.

Reversed and remanded.

SUPREME COURT OF THE UNITED STATES

No. 17.—OCTOBER TERM, 1968.

United States, Petitioner, *v.* The Donruss Company.	On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

[January 13, 1969.]

MR. JUSTICE HARLAN, whom MR. JUSTICE DOUGLAS and MR. JUSTICE STEWART join, concurring in part and dissenting in part.

I agree with the Court that the Court of Appeals erred in framing its remand order in this case. However, I would modify the order in a different way, which I find more in harmony with the statutory scheme than the one the Court has chosen.

Section 532 of the Internal Revenue Code of 1954 states in relevant part:

> "The accumulated earnings tax imposed by section 531 shall apply to every corporation formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . ., by permitting earnings and profits to accumulate instead of being divided and distributed."

Section 533 (a) provides:

> "For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."

Our task is to decide what jury instruction with respect to the definition of "purpose" comports best with Con-

gress' intent as revealed by this statutory language and the underlying legislative history.

I am in accord with much of the Court's opinion. I too find that the successive changes in the wording of the statute, even when read together with the legislative history, do not help in our inquiry. I too find that the legislative history reveals a progressive congressional intention to rely more and more heavily upon a comparatively objective criterion: whether the accumulated earnings were in excess of the corporation's reasonable business needs. Nevertheless, it is apparent from the language of § 533 (a), and from the legislative materials, that Congress chose still to give the taxpayer a "last clear chance" to prove that, despite the unreasonableness of the accumulation by business standards, the accumulation was not due to the proscribed purpose. My difficulty with the instruction approved by the Court is that in most instances it will effectively deny to the taxpayer the "last clear chance" which Congress clearly meant to afford and substitute a very fuzzy chance indeed.

I reach this conclusion on what I regard as commonsense grounds. In practice, the accumulated-earnings provisions are applied only to closely held corporations, controlled by relatively few shareholders.[1] As the Court admits, the shareholders almost always will have been advised that accumulation of corporate earnings will result in individual tax savings. That fact will be before the jury. In accord with the Court's decision, the jury will be instructed that "it is sufficient if [avoidance of shareholders' tax] is *one* of the purposes of the company's accumulation policy." (Emphasis supplied.)

Under these circumstances, the jury is very likely to believe that it must find the forbidden purpose and im-

[1] See S. Rep. No. 1622, 83d Cong., 2d Sess., at 69 (1954); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 213–214 (2d ed. 1966).

pose the tax whenever the Government shows that the taxpayer has accumulated earnings with knowledge of the resultant tax saving, irrespective of any contrary evidence put forward by the taxpayer. The approved instruction simply tells the jury that the taxpayer must have had a "purpose" to avoid individual taxes. In everyday speech, we commonly say that a person has a "purpose" to do something when he acts with knowledge that the thing will inevitably result. Even were the jury legally knowledgable, it might reach the same conclusion, for assuming that the word "purpose" as used in § 532 is synonymous with "intention,"[2] there is ample authority for the proposition that an actor will be deemed to have an "intention" to cause consequences of an act if "the actor . . . believes the consequences are substantially certain to result from [the act]."[3] To confront the taxpayer with this likelihood that its evidence of another purpose will be entirely disregarded is inconsistent with the provision of § 533 (a) which explicitly affords the taxpayer an opportunity to avoid the tax by showing "by a preponderance of the evidence" that it had a "contrary" purpose.

The Court, while conceding that the shareholders will know of the expected tax saving "in nearly every case," see *ante*, at 12, reasons that the taxpayer will have its

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[2] "Purpose" is listed as a synonym for "intention" in Black's Law Dictionary, at 948 (4th ed. 1968). Many courts have used the two words interchangeably in construing §§ 532 and 533 (a). See, *e. g.*, *Henry Van Hummell, Inc.* v. *CIR*, 364 F. 2d 746 (1966); *Youngs Rubber Co.* v. *CIR*, 331 F. 2d 12 (1964); *Smoot Sand & Gravel Co.* v. *CIR*, 241 F. 2d 297 (1957); *Henry A. Koch & Co.* v. *Vinal*, 228 F. Supp. 782 (1964); *Motor Fuel Carriers, Inc.* v. *United States*, 202 F. Supp. 497 (1962), vacated on other grounds, 322 F. 2d 576 (1963).

[3] Restatement (Second), Torts § 8A (1965). See also *id.*, Comment *b;* R. Perkins, Criminal Law 657–658 (1957); Cook, Act, Intention and Motive in the Criminal Law, 26 Yale L. J. 645 (1917).

opportunity because "[i]t is still open for the taxpayer to show that even though knowledge of the tax consequences was present, that knowledge did not contribute to the decision to accumulate earnings." *Ibid.* If, as appears from the Court's opinion, this exegesis is not to be a part of the jury instruction, then the Court is simply engaging in wishful thinking. If by chance the explication is to be included in the instruction, then the jury will be told to impose the tax only if it finds that a desire to avoid tax "contribute[d] to the decision to accumulate earnings." Such an instruction would at least inform the jury that the tax consequence must actually have been in the shareholders' minds when they decided to accumulate. However, once the shareholders are shown to have had knowledge of the tax saving, it still will be extraordinarily difficult for the taxpayer to convince the jury that the knowledge did not play some part, however slight, in the decision. Again, it seems to me that such an instruction would not give proper scope to the congressional intention that the taxpayer have a chance to prove "by the preponderance of the evidence" that it had a "contrary" purpose. I would therefore adopt an instruction less loaded against the taxpayer.

The Court of Appeals for the Sixth Circuit decided, and respondent argues, that the tax should apply only if the jury finds that tax avoidance was the "dominant, controlling, or impelling motive" for the accumulation. I agree with the Court that such an instruction would be improper. It apparently would require the Government to show that tax avoidance was stronger than any other motive, and perhaps that it was stronger than all other motives put together. This would largely negate the statutory presumption of improper purpose contained in § 533 (a). In my view, it would also result in nonimposition of tax in cases where Congress meant there

to be liability, for I think that Congress must at least have intended that the tax should apply whenever the taxpayer would have distributed, instead of accumulating, corporate earnings had there been no possibility of a tax saving.

These considerations suggest what I believe to be the best rule: the jury should be instructed to impose the tax if it finds that the taxpayer would not have accumulated earnings but for its knowledge that a tax saving would result. This "but for cause" test would be consistent with the statutory language. It would allow the Government to succeed if it could show, with the aid of the § 533 (a) presumption, that without the spur of tax avoidance the taxpayer would not have accumulated the earnings, thus giving effect to the presumption and fulfilling Congress' desire to penalize those with a "purpose" to avoid tax. It would permit the taxpayer to escape the tax if it could convince the jury that for other, perhaps irrational, reasons it would have accumulated even had no tax saving been possible, thus affording the opportunity for proof of a "contrary" purpose which Congress intended to provide. In addition, I believe that this instruction would be relatively easy for a jury to understand and apply. For all of these reasons, I consider it preferable to the standard adopted by the Court.